August 10, 2004

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Room TWB-204
Washington, D.C. 20554

RE: NOTICE OF EX-PARTE COMMUNICATION

Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112, CC Docket Nos. 00-175, 01-337, 02-33

Dear Ms. Dortch:

BellSouth, Verizon, and SBC hereby jointly submit the attached Declaration of William Taylor, Timothy Tardiff, and Harold Ware of NERA Economic Consulting ("NERA Declaration") in response to the June 8, 2004 AT&T *Ex Parte* Declaration of Dr. Lee Selwyn filed with the Commission on June 9, 2004 ("Selwyn Declaration"). The NERA Declaration not only refutes Dr. Selwyn's proposed post-sunset imputation but also overwhelmingly demonstrates that use of an economic imputation test is unnecessary and unjustified given the increasingly competitive telecommunications marketplace.

Dr. Selwyn's proposed imputation rules would far exceed Congressional intent, Commission precedent, and sound economic practice. He argues that such burdensome requirements are necessary to protect stand-alone toll service firms from alleged BOC anticompetitive pricing and to assign all of the benefits of integration to local services. However, as the NERA Declaration makes clear, Dr. Selwyn's recommendations are fatally flawed.

The primary weakness of Dr. Selwyn's recommendations is that they ignore the reality of the communications marketplace. The NERA Declaration provides ample evidence of the converging and robust nature of current and future competition to traditional wireline voice services from wireless, cable, broadband (including VoIP) and other emerging platforms. Even aside from the other flaws in Dr. Selwyn's arguments, the proliferation of platforms offering both local and long distance services by itself shows conclusively that the BOCs have no ability to engage in predatory pricing practices or otherwise adversely affect competition. As summarized below, the NERA Declaration explains why the rules proposed by Dr. Selwyn and AT&T are unnecessary and anticompetitive, and would be costly, inefficient, and harmful to consumers.

Unnecessary: Given the existence of price cap regulation for access and other services, imputing costs to regulated services would have no effect on prices for these services. It would only serve to restrict competition by creating price floors for the BOCs' long distance services.

- Imputation is not necessary to prevent predatory pricing by the BOCs. Pervasive competition in long distance services from a wide variety of sources means that sacrificing profits (by predatory pricing or a price squeeze) cannot be a profitable strategy for a BOC because driving rivals from the market is unlikely and recouping profits later by raising prices is impossible.
- Economics, the law, FCC precedent and previous AT&T filings all agree that an antitrust pricing analysis – be it fo r predatory pricing or an economic imputation test for an essential facility – should use some measure of forwa rd-looking incremental cost, not fully-distributed accounting costs as AT&T proposes here.

Anticompetitive: The price floors and accounting processes urged by AT&T would restrict the ability of one subclass of telecommunications suppliers -- the BOCs - to sell long distance services at competitive market prices and shelter other service providers (whether they are specialized firms or firms that provide integrated local, long distance, internet and other services) under a pricing umbrella.

Costly, inefficient and harmful to consumers: Such a pricing umbrella would penalize consumers by impeding BOC efforts to offer discounted bundled service, and allowing business to be diverted from BOCs to other less-efficient specialized and integrated firms that otherwise might not be as competitive. With changing technology and converging markets, adopting the AT&T proposal would needlessly burden BOCs and regulators, at a time when such regulation should be reduced.

In short, imposing these rules would cripple price competition for long distance services, thereby sacrificing the major source of consumer benefits stemming from the FCC's pro-competition policies of the past two decades.

In accordance with section 1.1206 of the Commission's rules, this letter is being filed in the above referenced proceedings. Should you have any questions regarding the attached, please do not hesitate to contact us.

Sincerely,

/s/	/s/	/s/
Mary L. Henze Asst. Vice President Federal Regulatory BellSouth	Michelle Thomas Executive Director Federal Regulatory SBC	Dee May Vice President Federal Regulatory Verizon

cc: Chris Libertelli
Matthew Brill
Jessica Rosenworcel
Dan Gonzalez
Scott Bergman
Jeff Carlisle
Jane Jackson
Michelle Carey
Bill Dever
Michael Carowitz
Cliff Rand

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	
Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	WCB Docket No. 02-112
2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules	CC Docket No. 00-175

Declaration of William E. Taylor, Timothy J. Tardiff, and Harold Ware,

National Economic Research Associates, Inc.,

On Behalf of BellSouth, SBC, and Verizon

August 10, 2004

Declaration Regarding Imputation Safeguards for In-Region Long Distance Service

I. INTRODUCTION

A. Qualifications

1. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc., head of its Communications Practice, and head of its Boston office located at 200 Clarendon Street, Boston, Massachusetts 02116. I have been an economist for over twenty-five years. I earned a Bachelor of Arts degree from Harvard College in 1968, a Master of Arts degree in Statistics from the University of California at Berkeley in 1970, and a Ph.D. from Berkeley in 1974, specializing in Industrial Organization and Econometrics. For the past twenty-five years, I have taught and published research in the areas of microeconomics, theoretical and applied econometrics and telecommunications policy at academic and research institutions including the Economics Departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology. I have also conducted research at Bell Laboratories and Bell Communications Research, Inc. I have appeared before state and federal legislatures, testified in state and federal courts, and participated in telecommunications regulatory proceedings before state public utility commissions, as well as the Federal Communications Commission, the Canadian Radio-television Telecommunications Commission, the Mexican Federal Telecommunications Commission and the New Zealand Commerce Commission.

2. My name is Timothy J. Tardiff. My business address is 200 Clarendon Street, Boston, MA 02116. I am a Vice President at National Economic Research Associates, Inc. (NERA). I have specialized in telecommunications policy issues for over 20 years. I received a B.S. degree from the California Institute of Technology in mathematics (with honors) in 1971 and a Ph.D. in Social Science from the University of California, Irvine in 1974.My research has included studies of the demand for telephone services, such as local measured service and toll; analysis of the market potential for new telecommunications products and services; assessment of the growing competition for telecommunications services; and evaluation of regulatory frameworks consistent with the growing competitive trends. Since the passage of the Telecommunications Act, I have participated in interconnection arbitrations, unbundled element proceedings, universal service investigations, applications by incumbent local exchange carriers for authorization to provide interLATA long-distance, and implementation of the Triennial Review Order rules for unbundling network elements, in over 20 states.

3. My name is Harold Ware. My business address is 50 Main Street, White Plains, NY 10606. I am a Vice President at National Economic Research Associates, Inc. ("NERA"). I have studied the telecommunications industry for over 25 years. My research has focused on: studies of competition in the directory assistance, local, interexchange, Centrex/PBX, and private line markets; studies of costs, pricing, and entry policy, and universal service issues associated with the transition to competition; analyses of competitive effects of mergers in wireless telecommunications and between telephone and cable TV companies; and analyses of the planning and deployment of new technology in telecommunications networks. I have testified before state regulatory commissions and the U.S. Postal Rate Commission, and filed affidavit testimony before the FCC and the Department of Justice. I received a B.A. *cum laude*

in Economics from the State University of New York at Stony Brook, and M.A. and Ph.D. degrees in economics from Cornell University. While pursuing my graduate studies at Cornell, I taught courses in economics and industrial organization and did research on cellular mobile telecommunications in the Technology Assessment Project of the Program on Science, Technology, and Society.

B. Purpose and Summary

4. This declaration addresses the expanded imputation requirements proposed by AT&T for toll services with the expiration of the Section 272 separate affiliate requirements. We consider AT&T's plea to impose a series of elaborate new accounting requirements to cope with the purported threat that BOCs could impose a price squeeze on firms that specialize in providing long distance services.

5. According to Dr. Selwyn, integration of BOC long distance services requires the following new imputation rules to protect stand-alone toll service firms and to assign all of the benefits of integration to local service: (1) imputation for ***non-access functions*** such as billing and collection, marketing, and even common overhead functions, to competitive services at the higher of fair market value or fully distributed costs; (2) service-by-service imputation price floors for every single competitive service (or even service components); (3) application of price floors to each competitive service and to each competitive component of a bundled service; (4) inferring the prices for competitive components of a bundle based on the difference in price between bundles with and without the competitive components; (5) expansion of Part 64 so that, among other things, all investment in joint use equipment is presumed to be for the non-regulated service and the cost is imputed to a price floor for unregulated services; and (6) dominant carrier treatment of the integrated BOC services to enforce regulatory restrictions and address what he considers to be the large and rapidly growing long distance "market shares" of the BOCs.

6. Dr. Selwyn's claims that new protections are needed are based on fundamentally flawed assumptions because they ignore that: (1) intermodal and intramodel competition has eliminated BOC bottleneck control over carrier access services; (2) AT&T itself has avoided switched carrier access for its business customers and has successfully competed to provide local services to these customers; (3) by any measure, BOCs do not have a dominant position in long distance market services; and (4) imposing price floors on the BOCs is not necessary to prevent predation and it would harm consumers. Thus, whether or not AT&T and others with similar business models find it difficult to compete with facilities-based LECs, cable companies, and wireless carriers, BOCs should not be hamstrung with new regulations that prevent them from meeting competition from other platforms. Regulatory policy is supposed to stimulate competition, not protect selected competition strategies. The robust competition that exists for toll service, including that from wireless and other new platforms that provide their own carrier access and all distance service, means that AT&T's policy proposal is unnecessary and harmful. Dr. Selwyn's recommendations are fatally flawed as a matter of economic principle. Even if there were a need for the types of pricing protections he recommends—and there is no such need—economic experts, including those who have testified on behalf of

AT&T, have rejected the cost allocation methods Dr. Selwyn recommends. More specifically, we conclude that:

1. The marketplace has changed dramatically

7. As a result of technological, policy and competitive developments, scores of telecommunications firms provide a range of offerings that include long distance and local services. More specifically:

- BOCs now compete with numerous companies, including cable firms, wireless mobile firms, DSL providers, VoIP firms, and CLECs as well as AT&T, MCI, Sprint and others that provide both local and long distance services.

- Wireless mobile services are a major source of competition for residence toll service (as AT&T has recognized in its financial filings), as well as for local services. Today, there are over 19 million *more* wireless subscribers than residence and small business conventional (ILEC + CLEC) access lines in the US.[1]

- In view of this competition and other forms of intermodal competition that completely bypass the local loop, BOC access services are not essential components of toll service.

- Bundled services are pricing strategies, not a separate relevant market, because combinations of à la carte services are extremely close substitutes for bundled offerings. Moreover, competition between à la carte and bundled offerings will continue because providers will continue to sell à la carte toll services to meet consumer demands (and ILECs, at least, will be required by regulation to provide local service on a standalone basis for the foreseeable future).

- While AT&T argues that BOCs have rapidly captured a large share of residential toll subscribers from *the BOCs' own embedded base* of local subscribers, the BOCs as a group have a small share of overall long distance. For example, wireless carriers, whose usage is growing, already carry over 40 percent of residential toll traffic; and AT&T alone has over 50 percent more toll revenues than the four BOCs *combined*.

- Thus, BOC toll service should clearly not be classified as "dominant."

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[1] FCC Local Competition Report: Status as of December 31, 2003, released June 2004, at Tables 2 & 13.

2. Competition, self-interest and existing regulatory safeguards render the prospect of anticompetitive behavior (e.g., price squeezes) extremely remote.

8. Apart from the fact that BOCs do not provide essential exchange access facilities to their intermodal competitors or facilities-based CLECs, they have neither the incentive nor the ability to impose a price squeeze by pricing bundled or stand alone toll services below competitive levels. This is true even if access services are priced above costs because: (1) doing so would reduce current profits; while (2) the absence of entry barriers giving rise to current and emerging competition will prevent the BOCs from recouping lost profits via subsequent price increases.

9. Moreover price cap/incentive regulation of interstate (and most intrastate) services—without earnings sharing or low-end adjustments—means that prices of regulated services are unaffected by the allocations of costs. Thus, misallocating costs to regulated services would not enable the BOCs to charge lower prices for competitive services, because it would not produce offsetting rate increases for regulated services.

3. The statutory imputation requirement should not be expanded to create *a priori* limits on price competition.

10. Section 272(e)(3) requires the imputation of access charges for accounting purposes, but it does not establish or require an imputation price floor or test for identifying anticompetitive behavior.

11. Given the intense intermodal (as well as intramodal) competition for all telecommunications services, carrier access is not an essential facility or service for toll competition. Therefore, before-the-fact imputation tests or price floors not only are inappropriate, but also would hinder competition.

12. Even an after the fact analysis of an alleged price squeeze (in the context of a § 208 complaint, for example) should not be based on fully distributed costing methodologies and over allocations of costs to toll services as proposed by AT&T. In addition, economic principles imply that such an analysis, if it were to be undertaken, should consider toll service as a whole rather than individual rate elements or toll plans. Imputation at a more granular level—e.g., for every service that has a separate price—would hinder competition and harm consumers.

4. Adopting the burdensome rules proposed by Dr. Selwyn on behalf of AT&T would impede competition and harm consumers.

13. AT&T, under the pretense of protecting competition, proposes a suite of onerous and unnecessary regulatory accounting and pricing rules designed to protect itself and other

established carriers from competition. These rules are unnecessary, anticompetitive, costly, inefficient, and harmful to consumers.

- Unnecessary: Given the existence of price cap regulation for access and other services, the only possible use of the regulatory accounting procedures AT&T advocates would be to set price floors for interstate services. But such price floors are unnecessary.
    - Pervasive competition in long distance services from a wide variety of sources (*e.g.*, wireless, cable, VoIP as well as traditional wireline sources) means that sacrificing profits (by predatory pricing or a price squeeze) cannot be a profitable strategy for an ILEC because driving rivals from the market is unlikely and recouping profits later by raising prices is impossible.
    - The accounting rules AT&T advocates should not be used as a "floor." Economics, the law, FCC precedent and previous AT&T filings all agree that any pricing floor — be it an antitrust predatory pricing safeguard or an imputation price floor accounting for some essential facility — that is based on cost should use some measure of forward-looking incremental cost, not fully-distributed accounting costs.
- Anticompetitive: The price floors and accounting processes urged by AT&T would restrict the ability of one subclass of telecommunications suppliers—the BOCs—to sell long distance services at competitive market prices. Thus, AT&T's proposal would prevent some suppliers from lowering prices to reflect their own incremental costs, while sheltering other service providers (whether they are specialized firms or provide integrated local, long distance, internet and other services) under a pricing umbrella.
- Costly, inefficient and harmful to consumers: Such a pricing umbrella would penalize consumers by impeding BOC efforts to offer discounted bundled service, and allowing business to be diverted from BOCs to other less-efficient specialized and integrated firms that otherwise might not be as competitive. With changing technology and converging markets, adopting the AT&T proposal would needlessly burden BOCs and the regulators, at a time when such regulation should be reduced.

In short, imposing these rules would cripple price competition for long distance services, thereby sacrificing the major source of consumer benefits stemming from the FCC's pro-competition policies of the past two decades.

II. TELECOMMUNICATIONS COMPETITION HAS INCRESED DRAMATICALLY

14. The telecommunications marketplace has changed dramatically since the 1996 Act was signed into law. Many of the goals of the Act have been achieved—i.e., the distinctions created by the 1984 break up of AT&T and by technological boundaries are no longer applicable. Among other things—contrary to the assumptions underlying Dr. Selwyn's proposed policy—

telephony services from cable firms, the widespread use of wireless and broadband services, and technological developments (including Voice over Internet Protocol, or VoIP) have literally transformed the telecommunications industry and greatly increased competition.[2]

15. First, long distance competition does not depend on LEC access facilities, i.e., LEC carrier access services are not essential for competitors to deliver toll calls, because numerous providers use their own facilities or CLEC facilities for this purpose.

16. Second, the BOCs do not have a dominant position in the toll market because: (1) the BOCs have a small share of the toll market and no ability to dominate given that the other platforms (e.g., cable, wireless, CLEC, VoIP) are growing extremely rapidly; and (2) numerous competitors use multiple platforms to deliver toll calls and those that still use conventional wireline access, including AT&T itself, have developed alternatives to BOC switched carrier access services in successfully competing to provide local and toll services.

17. This robust competition for all forms of toll service prevents the BOCs from being able to pursue predatory pricing practices.

A. ILECs facilities are not essential for provision of toll services because ILECs compete against many types of offerings and competitors, companies that bypass local access.

1. Cable firms provide (local and toll) telephone services as well as video and broadband.

18. Cable firms have greatly increased telecommunications competition by adding broadband data, and local and toll voice telephone services to their repertoire. Cable companies have already taken the lead in the provision of broadband services—serving about 17.4 million broadband customers as of March 2004.[3] Cable companies already offer circuit switched voice services to 15 percent of US households and have begun aggressively deploying VoIP service with plans to offer their own VoIP to more than 24 million homes this year, 20 million in 2005 and 82 percent of US households by the end of 2006. Moreover, 85 to 90 percent of US homes already have access to cable modem service and thus can already purchase VoIP from multiple providers including AT&T. Their presence and ability to achieve the substantial forecast growth is supported by the fact that VoIP offers cable companies an extremely low-cost way to completely bypass the BOC's access lines, and by the fact that cable telephony services are

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[2] For example, according to a recent analyst report: "[Consumer telecommunications] is also shaping up to be the battleground for emerging competitive services such as VoIP and there are many more types of companies today looking for a bite of the apple…. The cable industry and emerging Voice over Internet Protocol (VOIP) are almost entirely beholden the consumer marketplace." See Banc of America Securities, Equity Research, Research Brief Wireline Communications, Wireline Services Pricing Update, January 13, 2004, (cited below as Banc of America Securities Wireline Services Pricing Update) at 6.

[3] NCTA Industry Overview, http://www.ncta.com/Docs/PageContent.cfm?pageID=86, accessed July 22, 2004

priced extremely aggressively compared to BOC services, as well as additional information provided in Attachment 1.[4]

19. Cable companies are also targeting business customers in an effort that will let them take advantage of economies of scale and of scope. See Attachment 1.

2. Wireless providers compete for local and toll voice and data traffic.

20. Customers are increasingly relying on wireless phones for local and long distance calling, in many cases abandoning their wireline phones altogether. Nationally, wireless subscription increased dramatically from about 86 million subscribers in December 1999 to about 160 million in December 2003.[5] This growth along with the proliferation of wireless "buckets" of any distance, anytime minutes of use has made wireless services formidable competitors to wireline long distance and local services. For example, analysts found that wireless accounts for 23 percent of all voice minutes in 2003, could account for 29 percent in 2004, and wireless accounts for 43 percent of household long distance calling.[6] In contrast to gains by wireless carriers, average wireline toll volumes have declined substantially, according to the most recent FCC data.[7] AT&T's own financial filings confirm this substitution.[8] And, as discussed in Attachment 1, a substantial and rapidly growing number of customers have substituted wireless services in place of wireline local service.

3. VoIP, stimulated by rapid growth of broadband platforms enables bypass of conventional wireline access..

21. Competition is increasing from providers of voice services over broadband facilities, including VoIP and DSL firms as well as cable companies. (See our discussion of cable telephony above.) The massive and continuing expansion of broadband service from 7 million lines at the end of 2000 to 28 million by December 2003[9] adds to the competitive pressure on

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[4] Attachment 1 provides sources and notes for the data on cable telephony summarized above, as well as additional data on cable telephony. Cable telephony prices are described in Attachment 1 and in Section V.A below.

[5] FCC Local Competition Report: Status as of December 2003, released June 2004, at Table 13.

[6] See Attachment 1.

[7] See data in Attachment 1.

[8] "Stand-alone long distance voice services revenue has continued to decline due to competition and technology substitution (customers using wireless or Internet services in lieu of a wireline call)." AT&T 2003 Annual Report, at 4. Similarly, in its most recent quarterly earnings report the company stated its decline in consumer long distance revenues were "… driven by lower standalone LD voice revenue as a result of the continued impact of competition, wireless and Internet substitution and customer migration to lower-priced products and calling plans, partially offset by targeted price increases."

[9] Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, "High Speed Services for Internet Access: Status as of December 2003," June 2004, Table 1. ("FCC Broadband Report")

traditional wireline voice services.[10] First, this growth will stimulate the substitution of messaging for voice services. (See Attachment 1)

22. Second, VoIP technology provides a potent means for long distance companies to compete without using the BOCs' switched access services. Companies such as AT&T, Vonage and Packet8 enable residences to turn any broadband connection into a feature-rich phone service. VoIP providers are bundling local and long distance telephone services together with a host of features that complement the broadband connections. As shown in Section V.A, , these services are priced well below conventional wireline offerings.

23. Third, regardless of whether cable companies themselves offer VoIP, the 85-90 percent of U.S. homes that have access to cable modem service[11] also have access to VoIP from multiple providers ranging from the major long distance carriers to national VoIP providers. At the end of 2003 there were 150,000 U.S. VoIP subscribers. This number is expected to grow to 1 million by the end of 2004 and reach 6 million by the end of 2005.

24. Finally, broadband over power lines is emerging as another platform for the offering of voice services by VoIP carriers. As FCC Chairman Powell announced after reviewing a broadband over power line demonstration sponsored by AT&T and PG&E at AT&T labs:

> Powerline technology holds the great promise to bring high-speed Internet access to every power outlet in America. What I saw today has the potential to play a key role in meeting our goals to expand the availability and affordability of broadband. AT&T and Pacific Gas and Electric are to be applauded for leading the way for this innovative technology.[12]

The potential widespread availability of powerline broadband brings the potential to provide VoIP services to nearly every single home and office, without any reliance on the local network.

25. As evidenced by their own statements, "standalone" long distance carriers have alternative access technologies that enable them and others to compete with long distance services offered by wireless carriers, cable companies and BOC networks. For example, although AT&T has announced that: "the company will no longer be investing to acquire new customers in [the residential] segment," it simultaneously stated that it is "… concentrating its growth efforts going forward on business markets and emerging technologies, such as [VoIP], that can serve

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[10] Although DSL subscriptions are increasing rapidly of late, cable companies currently serve about 70 percent more broadband lines than DSL

[11] NCTA Industry Overview, http://www.ncta.com/Docs/PageContent.cfm?pageID=86, data for December 2003, accessed July 22, 2004.

[12] "FCC Chairman Powell: The Future is Bright for Powerline Broadband" FCC Press Release, July 14, 2004

businesses as well as consumers."[13] Thus, AT&T will continue to market its VoIP services to both business and residential customers. These services are already widely available; and the rapidity with which AT&T has deployed its CallVantage offering shows that entry barriers are low: "Today's market entries place us in 29 states and Washington, D.C.--that's100 major markets in just 16 weeks since service introduction… This demonstrates the velocity at which we're working to get IP technology into the hands of consumers."[14] Moreover, AT&T expects to sign up "1 million business and consumer users by year-end 2005."[15] AT&T's 2003 annual report reveals that AT&T:

- Is "… consolidating [its] legacy networks into a single global IP infrastructure, delivering the integrated, end-to-end solutions our customers demand, and fulfilling the promise of 'anything-to-anywhere' networking communications. [And,] … is well on its way to becoming the premier provider for … (VoIP) in all relevant market segments…."

- "[A]lready deliver[s] services directly to … customers' homes and premises over every major access technology, and we're leading the exploration into new alternate access technologies, such as broadband power line, free space optics and fiber to the home."

26. MCI, like AT&T is migrating its voice services to VoIP and other Internet based platforms:

> MCI plans to enhance its VoIP offerings around the globe in 2004….The company's VoIP product - called MCI Advantage - is a voice and data convergence service that …. is available over MCI's public IP network here in the U.S. By the end of March, MCI is making that service available over its private IP network, too. … DeMerlis [MCI Vice president of data and IP services] says MCI will expand beyond its traditional VoIP services to include Centrex and PBX-type capabilities. The Centrex and PBX services will be available this summer here in the U.S.
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> In a separate initiative, MCI plans to migrate its own voice traffic to its IP network core. A company spokesman said MCI fell short of that goal but is still on target to move all of its voice traffic to its IP core by 2005. [16]

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[13] AT&T Press Release: "AT&T Announces Second-Quarter 2004 Earnings, Company to Stop Investing in Traditional Consumer Services; Concentrate Efforts on Business Markets," July 22.

[14] AT&T News Release JULY 12, 2004 AT&T, "CallVantage Service Now Available in 100 Major Markets Coast-to-Coast Rollout Expands to 28 New Markets And Seven Additional States. $19.99 Promotion Offers Unlimited Calling and Advanced Features." http://att.com/news/item/0,1847,13134,00.html, accessed July 22, 2004.

[15] *Id.*

[16] Carolyn Duffy Marsan, "MCI beefs up VoIP offerings," Network World ISP News Report Newsletter, 03/31/04 http://www.nwfusion.com/newsletters/isp/2004/0329isp2.html, accessed July 27, 2004.

Moreover, in December 2003, MCI announced that:

> … it has entered into [an] agreement with Time Warner Cable to provide consumers with … [VoIP] communications services utilizing MCI's global voice and data network…. under the terms of the agreement, Time Warner Cable will be able to deploy its residential [VoIP service] nationwide. [MCI will provide] local points of interconnection to terminate IP voice traffic to the [PSTN], … deliver enhanced 9-1-1 service, local number portability [and] manage network integration and electronic bonding of both companies' order entry systems.
>
> "The time has come for a new solution that delivers all of the simplicity, quality and value that customers want - full service communications, high-speed Internet and video -- all in one package, on one bill, from a single provider," said Jonathan Crane, MCI executive vice president of Corporate Development and Strategy. "This relationship represents the next evolution in consumer communications - leveraging the added capabilities of cable and the global reach of the MCI IP network to create services that leave the old public switched network behind."[17]

4. Bundled and à la carte pricing plans provided by all types of carriers compete with each other.

27. Business and residential customers have a choice of bundled pricing plans that include toll services from numerous competitors who market the promise of convenient one-stop-shopping and one bill for multiple services. However, demand for any product or service is determined by price, perceived quality, and seller reputation, as well as features and convenience. And—as indicated by marketing materials and customer surveys—the primary attractions of bundled plans that include toll services are likely to be that: (1) bundled plans provide a discount over the stand alone services, assuming that customers make full use of the plans; and (2) those plans that offer unlimited calling volumes—e.g., free night and weekend cellular calling plans—allow consumers to reduce the uncertainty that comes from measured rates.[18] However, for many customers bundled pricing plans with unlimited or large blocks of long distance calling may not be attractive because, even with the discounts, the monthly charges end up

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[17] "MCI and Time Warner Jump on VoIP after FCC Announces Possible Regulations" http://www.mobilemag.com/content/100/344/C2290/, 12-8-03, accessed July 27, 2004.

[18] Bernstein Research found that: "Interestingly, 'single bill' is relatively unimportant to consumers. This confirms our prevailing view of bundles: their power to sway consumers rests almost entirely on the discounts that generally come along with them." C. Moffett, *et. al.* Bernstein Research Call, "Cable and Telecom: Bernstein Study Finds Consumers Ready and Willing to Switch to Cable Telephony." Dec. 9 2003, at 9. The study also confirms that customers make tradeoffs between discounts, brand and type of service – cable telephony or traditional phone service – as well as service quality and features.

being higher than those for the à la carte services purchased from separate carriers.[19] Thus, customers choose between bundled and stand alone pricing plans depending on the comparative pricing advantage. Indeed, while many customers have switched to bundled pricing plans, many customers still purchase à la carte telecommunications services.[20] Moreover, even customers who now buy service through bundled services pricing plans can switch back to à la carte offerings or switch to competing providers offering different or more attractive packages of services or a combination thereof. In short, customers choose the plan that is most attractive to their needs; and combinations of à la carte services are extremely close substitutes—nearly perfect substitutes, except for the convenience of "one-stop-shopping"—for bundles of services from a single provider. Thus, bundled pricing plans do not constitute a separate market from à la carte services; and, bundled services will continue to face competition from à la carte services because virtually all providers continue to sell à la carte services in parallel with their bundled services. Indeed, the following statement from AT&T's most recent annual report reveals that stand-alone wireline toll services compete with wireless and Internet services as well as with bundled services:

> AT&T Consumer Services long distance voice business has experienced similar trends as those of AT&T Business Services. Stand-alone long distance voice services revenue has continued to decline due to competition and technology substitution (customers using wireless or Internet services in lieu of a wireline call). We have introduced lower-priced calling plans to which many of our customers have migrated. In addition, customers are migrating to bundled calling plans that, while negatively impact stand-alone long distance revenue, positively contribute to growth in bundled revenue, although generally to a lesser degree, as bundled long distance pricing is lower. [21]

This statement also reveals that although AT&T may not like it, "bundled long distance service pricing is lower"; thus, consumers benefit from this practice.

B. ILEC long-distance offerings are a small part of the total, which includes all platforms by which customers make long distance communications.

28. As explained in Section V below, Dr. Selwyn's analysis greatly exaggerates the BOCs' long distance shares. In this section, we show that by any meaningful measure, the BOCs'

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[19] For example, according to Banc of America Securities: "Most unlimited bundled plans are not economic for typical LD users with an average crossover point of 401 minutes per month versus an average consumer use of 140 minutes." See Banc of America Securities Wireline Services Pricing Update, at 3.

[20] According to the Yankee Group only about 33 percent of households were subscribing to local and long distance from a single carrier. Kate Griffin, Yankee Group Consumer Technologies & Services "After the Fall: Reshaping the Wireline Industry," May 2004, at 4.

[21] AT&T 2003 Annual Report, at 4. Similarly, in its most recent quarterly earnings report the company stated its decline in consumer long distance revenues were "… driven by lower standalone LD voice revenue as a result of the continued impact of competition, wireless and Internet substitution and customer migration to lower-priced products and calling plans, partially offset by targeted price increases."

shares are small and that in light of the IXCs' much more substantial shares and of the rapid growth of other platforms, the BOCs have no prospect of attaining a dominant position in long distance services. For instance, AT&T's analysis ignores wireless carriers, who now account for about 43 percent of residential long-distance calling.[22] The most recent detailed FCC long distance revenue data for the entire industry are for 2002.[23] However, based on the first quarter 2004 financial statements we can make reasonable estimates of revenue shares. Note first that the first quarter financial statements show that the three largest IXCs' long distance revenues were more than 2½ times as large as the BOCs' long distance revenues in the first quarter of 2004. *AT&T alone had 52 percent more long distance revenue than the four BOCs combined.* Using first quarter 2004 financial statement data in conjunction with the relationships between the big three IXCs and other IXCs we estimate that the BOCs collective share of total long distance voice wireline revenues is about 21 percent.[24] This estimate likely overstates the BOCs' true share of long distance because it does not account for the role of wireless, Internet and other services that should be included in the calculation. Although precise measures of the BOC's shares of long distance including wireless are not available, we can gain some insight into the BOC wireline share of residential and small business based on total BOC long distance lines as a percentage of total wireless subscribers + residence and small business lines. Doing so shows that the wireline BOC share may be about 14 percent of the total. Finally, since other long distance carriers, wireless providers, CLECs, cable providers and VoIP providers also sell long distance voice services, and email and text messaging substitute for long distance calling, it is quite clear that the BOCs account for only a small part of the long distance business. Each of the percentages reported above pale in comparison to the approximately 60 percent market share AT&T enjoyed at the time the FCC granted its domestic interstate long distance service non-dominant status.

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[22] Yankee Group News Release, "U.S. Consumer Long Distance Calling is Increasingly Wireless, Says Yankee Group." March 23, 2004.

[23] FCC Analysis and Technology Division, Wireline Competition Bureau, *Trends in Telephone Service Industry,* May 2004, Section 9.

[24] *Id.* at Tables 9.6 and 9.7, and first quarter 2004 SEC 10Qs for AT&T, MCI, Sprint, Verizon, Qwest, SBC, and BellSouth.

III. UNDERLYING ECONOMIC FACTORS WOULD PREVENT THE BOCS FROM GAINING ANY BENEFIT FROM A PRICE SQUEEZE; THUS, ONEROUS NEW ACCOUNTING SAFEGUARDS WOULD SERVE NO PURPOSE

A. BOCs have neither the incentive nor the ability to engage in anticompetitive pricing in long distance services.

1. Market forces and policy changes have eliminated the ability of BOCs' to benefit from anticompetitive pricing.

29. Dr. Selwyn argues that the BOCs retain market power over local services that will allow them to cross subsidize their competitive toll operations and harm competition in the long distance market by engaging in a price squeeze. As described in Section II.A above, BOCs face extensive and growing competition from many different types of competitors and product offerings in local and long distance services, including competition from cable companies and wireless companies that completely bypass the wireline local switched network, and from VoIP over broadband facilities. Moreover, intermodal competition is rapidly expanding, particularly for toll traffic, as VoIP and wireless technology improvements continue to transform the marketplace.

30. Competition analysis is inherently forward looking. Thus, when considering the extent to which market forces will constrain BOC pricing behavior, the Commission should rely on a forward-looking view of competition that considers the extent of any barriers to competitive entry and the presence of competitors that can or do provide services that customers can substitute for an incumbent's services and to which customers will shift their demand should a firm raise the prices. These considerations affect the extent to which a BOC can exercise market power – *i.e.,* the power to raise prices or reduce quality and output in the relevant service market. If existing competitors can readily expand their output and/or enter the market if a BOC were to increase price, their elasticity of supply will undermine any efforts to exercise market power. Similarly, if consumers have substitutes for BOC services (or can, to some degree, do without them), then demand elasticity will do the same. The 1996 Act eliminated legal, regulatory and economic barriers to entry by allowing use of various combinations of resale, UNEs and their own facilities to enter or expand their capacity and capture customers beyond the geographic areas and/or specific market segments they are currently serving.

31. Recent developments (including especially VoIP technology) have driven costs down and greatly reduced the time it takes to compete in the long distance market via voice over broadband (cable modem or DSL) connections. VoIP has also greatly reduced costs to cable TV firms wishing to provide voice services to their video customers (whether or not they subscribe to broadband). These factors coupled with the growth of cable telephony, the dramatic growth of broadband coupled with the accelerating deployment of VoIP, and the dramatic growth of wireless services show that any BOC effort to engage in predatory behavior such as a price squeeze would be unprofitable because it would be unlikely to eliminate competition and impossible to recoup foregone profits through subsequent price increases. Taken together, the actual competition and the potential for increased competition eliminate

any effective market power BOCs may have had. Thus, AT&T's claim that the BOCs retain market power sufficient to benefit from anticompetitive leveraging is incorrect. The BOCs have no ability to dominate the market or engage in a successful predatory pricing strategy such as a price squeeze.

32. Note also that the requirement that ILECs allow competitors to use their facilities on a resale basis will further prevent anticompetitive pricing strategies. The 1996 Act establishes a wholesale (resale) discount applicable to any BOC retail telecommunications service a competitor wants to resell. The resale discount guarantees that any efficient telephone service provider can obtain a BOC's retail services to resell to its own customers at a cost that is equal to the retail price less the costs that the BOC avoids by selling its service at wholesale. By itself, the resale requirement eliminates the possibility of an anticompetitive price squeeze.

2. The BOCs have no incentive to engage in an anticompetitive price squeeze

33. When evaluating the potential for anticompetitive pricing in a market, economists generally consider two related types of anticompetitive pricing practices: predatory pricing and vertical price squeezes. Either practice entails pricing a service below the marginal cost of supplying the service[25] (*i.e.*, purposefully losing profit for a period) with the intention of permanently driving a rival from the market and then raising prices to recoup losses and earn supracompetitive profits going forward.

34. In theory, a price squeeze could occur in situations in which a firm: (i) controls an upstream essential[26] facility; and (ii) competes in the downstream retail market. While the second condition holds true for the LECs, we have shown above that the first does not. Competing providers of long distance services do not need to rely at all on the traditional wireline circuit-switched network – cable companies, wireless companies, and VoIP providers can offer the full panoply of telephony services without relying on the local network.

35. The BOCs would have no economic incentive to engage in predatory pricing by a price squeeze or any other means. Sacrificing current profits with the intention of driving competitors out of the market is not a likely recipe for profit under the best circumstances. In a predation strategy, the losses or reduced profits are certain and occur immediately while recouping the losses is uncertain and occurs in the future. Given that a dollar today is worth more in the future, in order to recoup the equivalent of dollar loss today the firm would have to make up in monopoly profits far more than a dollar in the future. Thus, even if the firm could drive competitors from the market and even if barriers to entering the market were prohibitively

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[25] In the case of a price squeeze, the marginal cost includes any profits foregone in supplying the service at retail in lieu of providing access to competitors.

[26] An essential facility is a monopoly input that competitors must purchase that cannot be economically duplicated. See, for example, Jerry A. Hausman and Timothy J. Tardiff, "Efficient Local Exchange Competition," *Antitrust Bulletin*, Fall 1995, pp. 529-556.

high (assumptions which are not the case in telecommunications markets), a predatory strategy is extremely risky. In the words of the Supreme Court:

> the success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain...For this reason, there is a consensus among commentators that predatory pricing schemes are rarely tried and even more rarely successful.[27]

36. Given the intense competition described in Section II above, telecommunications markets are far from the best conditions for successful predation. First, the Telecommunications Act of 1996 removed whatever vestigial legal, regulatory or economic barriers to entry into local exchange service, and state regulatory authorities, the Justice Department and the FCC ratified the opening of U.S. local exchange services in their Section 271 decisions.[28] At the same time, the Act expanded competition in long distance services by allowing the BOCs to enter once they complied with the "competitive checklist." Without barriers to entry in any telecommunications market, there is no way that an ILEC can raise prices for long distance services in order to recoup its lost profits and thus no way that the strategy could be profitable.

37. Second, ILEC competitors have incurred fixed and sunk costs, and those network facilities do not leave the market even if the competitors do. That is, they remain in place and can be used by new firms entering the market in response to any profitable opportunities.[29]

38. Third, a BOC would have no incentive to attempt an anticompetitive price squeeze because, even if the firm were successful in eliminating competition, and even if it subsequently raised rates, recoupment would be unlikely because such conduct would subject the BOC to increased regulation.

39. For these reasons, the potential threat of anticompetitive pricing is trivial, and it is used primarily as an argument by competitors to control and reduce the amount of price competition in a market. Indeed, any regulatory body should be wary of any attempt by an industry to use regulatory authority to prevent firms from entering a market, competing, or lowering prices. In a recent summary of the U.S. experience with economic regulation, FCC economist Peyton Wynns concluded that "[l]imiting entry to ensure a healthy industry is an inherent contradiction. [Footnote: It would be hard to find economists who think that predatory pricing

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[27] *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

[28] And as part of its assessment of whether entry was in the public interest, the FCC concluded that there were sufficient safeguards in place so that the local market will remain open. See, for example, Federal Communications Commission, In the Matter of Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in the State of New York, CC Docket No. 99-295, December 22, 1999 at ¶ 429.

[29] Dennis L. Weisman, "The Law and Economics of Price Floors in Regulated Industries," *The Antitrust Bulletin*, Spring 2002, pp. 107-131.

is a reasonable worry.]"[30] In particular, one of the main benefits from competition in local exchange services is the lower prices (and better quality and packaging of services) that the incumbent's customers receive.

40. The goal of introducing competition in telecommunications markets is to replace regulation with market forces that result in lower overall prices for consumers, increased service offerings and improved service quality. Vigorous price competition among incumbents and entrants is not anticompetitive; rather it is what one observes in unregulated, competitive markets and leads to increases in economic welfare. All customers are better off without price umbrellas. Thus, no price floor and cross-subsidy test is needed in today's market.

B. Price cap regulation at the federal and state level has made it impossible to subsidize a price squeeze by raising rates for access services.

41. As we describe in detail later, the link between regulated prices and accounting costs has been severed as a result of the evolution of price cap plans at both the federal and state levels. While these plans maintained such vestiges of rate-of-return regulation as earnings sharing in their early vintages, these features have long since been abolished. Thus, there is no ability for a BOC to increase prices of less competitive services (e.g., regulated basic exchange service) as a result of a "misallocation" of accounting costs away from more competitive services.[31] Thus, the feasibility of a price squeeze is further constrained by the BOCs' inability to recover lost toll profits through increased rates for exchange and/or exchange access services.

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[30] Peyton Wynns, "The Limits of Economic Regulation: The U.S. Experience," Federal Communications Commission, International Bureau Working Paper Series, Vol. 2, June 2004, at 12.

[31] On these grounds, state regulators and Federal courts have ruled that price cap regulation can be an effective safeguard against cross-subsidization and other such anticompetitive behavior. See, for example,

> [A] well designed price cap plan insulates ratepayers from investment risk and subsidization of new ventures. Massachusetts Department of Public Utilities, *NYNEX Price Cap*, D.P.U. 94-50 (May 12, 1995), p. 121.

> A properly designed alternative regulation plan affords the opportunity not only for the Company to transition itself to a more competitive environment, but allows this Commission to implement safeguards and allocate risk in a fashion that protects the interests of all interested parties. Illinois Commerce Commission, 92-0448/93-0239 Consol. (October 11, 1994), p. 19.

> [T]he FCC has taken specific affirmative steps designed to deter and detect cross-subsidization by introducing price caps as well as further strengthening its cost accounting rules. We conclude that with the implementation of these measures, the FCC … has demonstrated that the BOCs' incentive and ability to cross-subsidize will be significantly reduced. *California v. FCC*, No. 92-70083 and Consolidated Cases, 39 F.3d 919 (9th Cir. 1994) ("California III") at 926-927.

> [Price cap regulation] reduces any BOC's ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling. *United States v. Western Elec. Co.*, 301 U.S. App. D.C. 268, 993 F.2d 1572 (D.C. Cir.), cert. Denied, 114 S. Ct. 487 (1993) at 1580.

C. BOC's cannot succeed in a predatory price squeeze

42. In summary, under the circumstances described above, Dr. Selwyn's suggestion of BOC anticompetitive strategies that involve the sacrifice of short-term profits, i.e., predatory pricing and price squeezes, makes no economic sense, because (1) there is no prospect that ILECs can drive competitors from the market and barriers to entry are low so that (2) there is no prospect for recouping the profits that would be thrown away by below-cost pricing; and (3) ILECs cannot recoup lost toll profits by raising rates to customers of price cap services by over allocating common costs since such allocations have no impact on the prices of protected services.

IV. THE COMMISSION SHOULD NOT ADD TO THE IMPUTATION PROVISIONS OF THE ACT.

43. As explained above, the intense intermodal (and intramodal) competition assures that BOC supplied access services are not essential for competitors to provide toll services, and the economics of competition for long distance service assures that a price squeeze could not be used to drive competitors from the market and keep them out long enough to recoup the profits that would be lost while a price squeeze was attempted. Thus, before-the-fact imputation price floors are not needed. Moreover, absent the continuing requirement of §272(e)(3), eliminating imputation completely would not be premature because BOCs neither currently possess nor are likely in the foreseeable future to possess sufficient market power to disadvantage either competitors or customers. More generally, there is no economic basis for imposing pricing constraints on the BOCs retail long distance services as AT&T proposes. For example, not only are the opportunities for complete bypass of ILEC facilities in the provision of toll services already substantial and growing more so, but the fact that competition can occur with the type of access arrangements available for conventional long-distance is illustrated by the many historical examples of successful competition with ILECs, e.g., intraLATA toll where entrants entered and captured large shares of services that had a long history of regulated monopoly, wireless services.[32]

44. In this section, we explain that imputation, as the term is used in §272(e)(3) of the 1996 Act, ("§272(e)(3) imputation") does not require before-the-fact price floors of any type, and, indeed §272(e)(3) imputation is not the type of imputation that is used to determine price floors to assess whether prices are low enough to cause a price squeeze.

45. Moreover, an after-the-fact imputation analysis of an alleged price squeeze, (in the context of a § 208 complaint for example), if it were to be undertaken, would have to be based on

[32] For example, despite the fact that California's ILECs had regulated monopoly status in local (intraLATA) toll until 1995 and that dialing parity was not established until 1999, a recent report by the California Public Utilities Commission indicated that they have a share of *under 50 percent* of that market. Indeed, the ILECs' share declined from 66 percent in the Commission's previous report. California Public Utilities Commission, "The Status of Telecommunications Competition in California, Third Report for the Year 2003," October 31, 2003

incremental costs, not fully distributed cost allocations. Accordingly, to assess whether retail prices have been set low enough to create a price squeeze, an "economic imputation" analysis should be used. According to economic principles, this analysis:

- Is warranted only for essential facilities; and
- Should consider toll service as a whole rather than individual rate elements or toll plans. Imputation at a more granular level—e.g., for every service that has a separate price—would only hinder competition.

(In Section V, we explain that fully distributed costing methodologies and over-allocations of costs to toll services as proposed by AT&T have no economic meaning and if adopted would undermine economic efficiency.)

A. Imputation under Section 272(e)(3)

46. Section 272(e)(3) states that a BOC shall: "… impute to itself (if using the access for its provision of its own service), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service." Thus, §272(e)(3) imputation, under the Act, as written by Congress, focuses on an accounting safeguard to be used to determine appropriate regulated accounting practices to prevent cross subsidies and discrimination against non-affiliated carriers. This form of imputation should not be given any role in establishing prices for long distance services, because as we discuss in section V below, even in the absence of an imputation rule, pricing rules for regulated services have evolved to a pure price cap model that severs the links between rates and accounting costs.

B. Applying economic principles to after-the-fact pricing assessments

47. Economic imputation principles are sometimes used to assess whether a firm that competes for a retail service and controls an essential facility has engaged in anticompetitive pricing. As explained above, there is no need to introduce a before-the-fact economic imputation test to deter a price squeeze. As explained in Section V below (1): there is no need to add to the scope of the statutory accounting imputation requirement (as AT&T requests); and (2) if the Commission were to contemplate a prospective economic imputation test—which it should not—it should definitely not adopt the anticompetitive proposal described in Dr. Selwyn's affidavit for AT&T. In this section, we explain how economic principles would be applied if an after-the-fact analysis were performed.

48. To test whether an anticompetitive price squeeze has occurred using economic imputation one would first assess whether an essential facility is present that could permit a price squeeze to occur. Then, *if and only if a firm controls an essential facility*, one would assess whether the revenues from a line of business exceed the (forward-looking) direct incremental cost of the

relevant line of business plus the contribution (revenues minus incremental costs) from essential facilities, e.g., access services used to compete for that line of business, that competitors must purchase from the LEC in order to compete.[33] When a firm controls an essential facility, the incremental cost of selling the retail service includes the opportunity cost of the contribution that the firm could have made by selling access. However, when the firm does not control an essential facility, then that contribution is no longer part of the incremental cost because the firm would not necessarily have been able to make any contribution above its own direct incremental cost.[34] In this case—i.e., in the current competitive telecommunications environment—a price squeeze is not economically feasible. Thus, to test for whether anticompetitive pricing has occurred, one would assess whether the revenues from a line of business exceed the (forward-looking) direct incremental cost of the relevant line of business. As explained below, assessment of an anticompetitive pricing allegation should consider the overall economic market—not individual service plans or service components. Thus, to avoid suggesting that imputation is needed for a single service, we refer to competition, and revenues and costs for a "line of business," in our discussion of economic imputation.

1. Imputation is not necessary because the BOCs do not control essential facilities.

49. The potential for a price squeeze arises from essential facilities, not from facilities that competitors can self-supply, or obtain in the market from third parties. For example, Baumol and Sidak state that the ECP [efficient component pricing rule] or economic imputation "arises generically whenever a firm, X, is the ***only*** supplier of an input used both by itself and by a rival to produce some final product."[35] Similarly, Baumol, Ordover and Willig, state that such rules are needed: "When several firms compete … in the sale of an identical final product,

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[33] Economic imputation is similar to (but more correct than) imputation tests that require comparisons of the retail charges with the sum of access prices plus non-access costs for the retail service. By considering the contribution (or profit) foregone in not selling access to essential facilities to competitors, the economic cost in engaging in the line of business appropriately includes opportunity costs. This general formulation of a price squeeze test can be restated using special cases that are perhaps more familiar. For example, consider a simple example in which a retail service requires one unit of access, whose price is 3 cents and cost is 1 cent (independent of whether it is sold to a competitor or self-supplied) and one unit of non-access, whose cost to the provider of access is 2.2 cents. Under these assumptions: (1) the access provider's cost of providing the retail service is 3.2 cents (1 cent for access and 2.2 cents for non-access), (2) the contribution from access is 2 cents (3 cents – 1 cent), and therefore, (3) the minimum pro-competitive price is 5.2 cents (3.2 cents + 2 cents). But in this example, the minimum price can also be calculated as the *price* of access (3 cents) plus the *cost* of the access provider's non-access component (2.2 cents). Any competitor that was more efficient in providing non-access (i.e., had a cost of less than 2.2 cents) could enter and those that were less efficient would lose money by entering if, in fact, the retail price were set at the minimum. That is, the relevant consideration is not whether particular competitors have sufficient margin to compete, but whether those competitors that are at least as efficient as the access provider in supplying non-access can enter and make money.

[34] See, for example, Hausman and Tardiff, *op. cit.*, pp. 543-545 and Weisman, *op. cit.*, pp. 120-121.

[35] William J. Baumol and J. Gregory Sidak, *Toward Competition in Local Telephony*, Cambridge: MIT Press, 1994 at 92. Emphasis added. The ECP is a mathematically equivalent statement of the maximum pro-competitive access price (as opposed to the minimum retail price) of the integrated provider.

where one of the firms ***is the monopoly owner of an input*** that is indispensable in the supply of that product…."[36] There is no economic reason to apply imputation to non-essential facilities because no competitor is disadvantaged by whatever price an ILEC might set for an input that is competitively provided. Because, as set forth above, there are a wide variety of alternative means of obtaining access services or their functional equivalent, the imposition of an imputation test here is inappropriate.

2. Economic imputation—if applied—must be applied at a meaningful level.

50. If it is undertaken at all, an economic imputation analysis must be applied to an economically relevant set of services, i.e., to lines of business for which competitors make business decisions that affect the profitability of their firms. Conversely, unduly narrow imputation requirements—e.g., application on a service plan by service plan basis or to service components—would simply force certain prices to be too high, which while possibly benefiting certain competitors, would harm consumers and the competitive process. To understand why economic imputation is only meaningful at the level of a relevant product and geographic market consider a case in which a firm offers off-peak calls that are priced below the price of carrier access. This would not harm competition since no carrier competes just for off-peak calls. Similarly, from a geographic perspective, suppose—as the Commission has previously determined—the LD market is national: customers choose one carrier for all calls, irrespective of jurisdiction or distance. Then, if economic imputation is applied to the overall market, no IXC is prevented for competing for such customers if a competitor's intrastate toll prices in one state fail an intrastate-only imputation test. Requiring application of the imputation rules (or attempting to infer the existence of a price squeeze) at a more detailed level than that of relevant markets not only would make competition less vigorous (because of the extra burdens placed on certain competitors in introducing and pricing certain offerings), but would also increase the complexity and costs of designing, administering and monitoring the imputation standard. (See Section V below.)

51. As explained above, competitors provide a range of bundled and á la carte services that compete for customers' communications budgets. Thus, the relevant market is no less than all toll services, and may well include at least all voice and data services. In these circumstances, there are at least three reasons why the analysis of the presence or absence of price squeezes[37] is economically meaningful only at an aggregate level.

- First, in judging whether the price of an individual plan is anticompetitive, it is important to distinguish between pricing plans that make it difficult for individual competitors to compete and policies that harm the competitive process.

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[36] See William J. Baumol, Janusz A. Ordover, and Robert D. Willig, "Parity Pricing and Its Critics: A Necessary Condition for Efficiency in the Provision of Bottleneck Services to Competitors," *Yale Law Journal*, Vol. 145, 1997 at 147. Emphasis added.

[37] Which an explicit *before-the-fact* price floor based on economic imputation principles is designed to prevent.

- Second, pricing flexibility is an important asset for all competitors and imposing a restriction that applies only to one firm could bias the outcome of competition. Each firm has market niches for which its services have a comparative advantage, and pricing restrictions should not prevent a firm from developing and serving markets for which it is uniquely suited.

- Third, different pricing plans and different types of toll services are, to a large extent, substitutes for one another. Consequently, any firm's price for a particular pricing plan or market power for a particular toll service is limited by the presence of other pricing plans and other types of toll service.

52. Assessing whether prices are procompetitive over (at least) the aggregate toll market would properly recognize that prices and incremental costs are effectively averaged over geographic areas (as is required by the Telecommunications Act of 1996), different toll services, times of day, customer sizes, and lengths of haul. Then, any competitor with lower incremental costs (averaged as above) could enter and charge a price (averaged as above) lower than that of the BOC. In this aggregate sense, economic efficiency would be preserved because, averaged across the line of business, an efficient competitor will have a cost-based (average) competitive advantage in setting its price.

53. In this regard, the FCC's recent price squeeze remand order in the Massachusetts 271 proceeding is informative. The Commission declined to conclude that AT&T's and MCI's simplistic analyses of retail-wholesale margins for UNE P (which is essentially equivalent to the types of price floors that economic imputation would establish) were indicative of a price squeeze. Instead, it emphasized such entirely relevant facts as (1) certain competitors do not even rely on ILEC inputs, (2) AT&T and MCI themselves were charging retail prices comparable to Verizon's, and (3) not just the revenues from local services, but entire revenue streams, must be considered in assessing whether competition can occur. In assessing the competitive significance of whether particular competitors might face unattractive margins between the wholesale prices ILECs charge and the retail prices against which they must compete, the FCC noted the significance of such situations:

> *depends on the competitive characteristics of the state telecommunications market across all zones and modes of entry. In conducting such an analysis, we must consider evidence of a price squeeze along with evidence of how much the alleged price squeeze affects competition state-wide and the state of or potential for competition by other modes of entry, including facilities-based entry and resale.* Thus, the competitive significance state-wide of any demonstrated price squeeze must be taken into account, along with other factors, in determining whether such price squeeze amounts to a violation of the public interest requirement.[38]

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[38] In the matter of Verizon New England *et. al.* for Authorization to Provide In-Region, InterLATA Services in Massachusetts, *Order on Remand,* CC Docket No. 01-9, released February 20, 2004, at ¶ 11 (emphasis added).

No procompetitive purpose would be served by requiring that a BOC's toll price equal or exceed specific levels for individual times of day, for calls of particular lengths of haul, for particular geographic areas, for customers of a particular size class, or for particular toll services. In each of these cases, no prospective toll provider would be disadvantaged by ILEC prices that were fair when averaged over the entire line of business, but which resulted in toll prices that could be "too low" and some that could be "too high."

3. Before-the-fact imputation is not required on the basis of economic factors.

54. At the risk of some repetition, we feel it important to state that in light of (1) the BOCs' clearly nondominant position in long-distance and (2) the plethora of competitive offerings, insistence on mechanical application of a price floor based on imputation tests would be anticompetitive and counterproductive. As a practical matter, such floors are inherently inaccurate: costs and revenues vary by customer, by location and over time in ways too complex to be reflected in a single price floor. An imputation test uniformly applied to all circumstances is thus inherently arbitrary because it ignores many considerations that distinguish competitive from anticompetitive pricing. And, as noted above, seeking to apply imputation at a detailed level will harm competition.

V. ADOPTING DR. SELWYN'S PROPOSAL ON BEHALF OF AT&T WOULD BE AN UNECESSARY, HARMFUL EXPANSION OF THE COMMISSION'S RULES

55. Regulators should always be wary of any party proposing rules to prevent or constrain price reductions. As Professor Baumol wrote 25 years ago:

> … the vast preponderance of regulatory and antitrust pricing cases, and almost all of the pertinent discussions, has been devoted to the limitations of price *reductions* rather than price *increases*.
>
> There is a very simple explanation for this anomaly. A seller's high prices are likely to be harmful to *customers*, but his low prices are apt to harm his *competitors*. The competitors (who themselves are often giants of industry) are in a far better position to organize effective protest than are the customers. Inscribing on their banners, "fairness in competition," "prevention of predatory pricing" and other equally persuasive mottos, they have not only succeeded in making headway among regulators, but they have even managed to shield themselves from the rigors of competition.[39]

[39]William J. Baumol, "Minimum and Maximum Pricing Principles for Residual Regulation," *Eastern Economic Journal*, Vol. V, 1979, p. 236; emphasis in the original.

AT&T's filing is a classic example of a firm seeking protection <u>from</u> competition at the expense of consumers.[40]

A. Dr. Selwyn's imputation tests are too granular and economically meaningless; thus, adopting them would hinder competition and reduce economic efficiency

1. Dr. Selwyn's proposal would lead to excessively detailed application of imputation.

56. Dr. Selwyn's argument that imputation should be applied to á la carte services is incorrect because the "services" are not defined meaningfully. Dr. Selwyn would require imputation to be applied to service components, not to meaningfully-defined services or lines of business that approximate economic markets: for example, he argues that "… the price floor needs to be satisfied individually for each of a BOC's various long-distance services and pricing options…."[41] Adopting this recommendation would needlessly constrain competition. For example, the vast majority (if not all) long distance providers offer intraLATA toll, intrastate interLATA toll, and interstate InterLATA toll calling as part of their service; however, Dr. Selwyn's proposed approach would apparently require each of these service components to separately pass an imputation test even though failure to pass such a test would not harm competition because competition takes place for "all distance" toll services. AT&T clearly recognizes this because when SNET entered the long distance market in Connecticut and began eroding AT&T's market position by offering lower interstate rates, AT&T instituted a new *intra*state toll price of 5 cents per minute, notwithstanding that intrastate access charges at the time appear to have been over 5 cents per minute.[42] Under its plan customers obtained the 5

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[40] Ironically, AT&T long ago correctly recognized the harms to competition that handicapping specific competitors entail:

> …some of AT&T's competitors contend that a variety of AT&T competitive "advantages" warrant continued imposition of regulatory handicaps on AT&T. These contentions are unsupportable…More fundamentally, the competitors confuse competition with the improper protection of individual firms. The whole point of competition is to encourage firms to develop "advantages" and to exploit them by passing efficiencies on to consumers. The system of handicapping proposed by the competitors is the very opposite of competition, and can only harm consumers.

Reply Comments of American Telephone and Telegraph Company, In the Matter of Competition in the Interexchange Marketplace, CC Docket No. 90-132, September 18, 1990, at p. 5.

[41] Selwyn Affidavit at ¶ 22.

[42] According to SBC, the terminating rate for carrier access charges in Connecticut was about 2.7 cents per minute. Thus, assuming that originating rates were about the same carrier access charges came to about 5.4 cents per minute.

cents rate, regardless of the time of day guaranteed for a full year *but only by subscribing to AT&T's interstate long distance services.*[43]

2. Dr. Selwyn's proposed rule for bundled services ignores how competition takes place and would needlessly stifle competition.

57. According to Dr. Selwyn, imputation must be applied to each competitive service <u>component</u> of a bundle because the components of the bundles face "widely varying competitive conditions…." and, because "[b]undling of local and long distance services enables the BOC to exploit its market power with respect to local dial tone service into adjacent long distance markets."[44] The purported bases for his required imputation test for each component of a bundled service do not withstand scrutiny. First, whether components of the bundle are subject to differing levels of competition and regulation does not in any way imply that the price for the bundle or any element in that bundle is anticompetitive. As long as the traditionally regulated components of the bundle remain available on an unchanged, standalone basis, the bundle *is* sold in a competitive market. Every bundle the ILEC proposes faces a near-perfect substitute, namely the combination of standalone regulated services at tariffed rates and competitive services at market rates as well as the substitutes for the regulated services.

58. Second, as explained above, BOCs do not retain market power over local dial tone service because of the competition and potential competition facing the BOCs, and because as Dr. Selwyn admits,[45] basic rates are subject to regulation. Thus, the claim that the BOCs retain market power sufficient to benefit from anticompetitive leveraging is incorrect.

59. Third, Dr. Selwyn claims that BOCs have pricing discretion over vertical features, and they can use those profits to cross-subsidize toll. This claim ignores the fact that they cannot benefit from doing so. Not only would the BOC simply lose money on the subsidized toll services; raising rates for vertical services would increase the attraction of competitive alternatives to BOC local services (as well as competitive alternatives to specific vertical services, such as answering machines for voicemail). Moreover, if the higher vertical service rates were used to lower toll rates, revenues from the overall bundled service would likely remain the same; so that the numerous competitors offering bundled services would not be affected by this strategy.

60. Fourth, Dr. Selwyn's alleged concern about bundled service pricing is undermined by the fact that the marketplace already includes competitors offering bundles of local service, features and toll priced below the prices cited by Dr. Selwyn as examples of alleged BOC anticompetitive pricing and/or offering more services in the bundle at a somewhat higher price.

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[43] "AT&T Offers 5 Cent Rate in Connecticut," *Business Wire,* May, 1996. This competitive response enabled AT&T to answer SNET's lower rates without lowering interstate prices elsewhere. Rate averaging rules prevent AT&T from lowering its interstate rates in Connecticut without also lowering rates elsewhere.

[44] Selwyn Declaration at ¶¶ 19, 20

[45] Selwyn Declaration at ¶¶ 20

More specifically, according to Dr. Selwyn, Verizon offers customers in Eastern Massachusetts a bundle of local service, vertical features and ***intra***LATA toll for $39.95, and it offers New York Metro LATA customers a bundle including unlimited local and intraLATA toll, plus an array of vertical features for $44.95. He then argues that these prices would be anticompetitive, if the effective toll price—i.e., the $2.00 difference between the these package prices and the packages without intraLATA toll—does not exceed the price floor that he proposes.[46] However, these prices clearly do not present any competitive problems because many competitors offer bundles with these services and additional services at lower prices. For example our review of plans for a sample of well known carriers in each area shows that Vonage, AT&T CallVantage (VoIP offering), IDT, wireless plans, and cable telephony plans offering unlimited interLATA as well as the services in the Verizon regional packages cited by Dr. Selwyn are available for lower or comparable rates to the Verizon plan. The AT&T VoIP, Vonage, IDT, and Cablevision plans offer unlimited long distance as well as intraLATA calling, yet are cheaper than the Verizon plans cited by Dr. Selwyn. Note that the lower-priced wireless plans we reviewed AT&T mLife National, and T-Mobile Get More National, offer unlimited night and weekend toll and local calling, and 600 anytime minutes that can be used for local or toll. Cigular Nation costs more than the Verizon Regional plans but, unlike those plans it covers interLATA calls. The following table shows our comparisons in more detail:

[46] Selwyn Declaration at ¶23.

Examples of Bundled Voice Service Plans: July 2004

Boston

Package Plan	Price	Wireless Anytime Minutes	Local Calling	Local Toll Calling	Long Distance	Add'l Calling Features	Voicemail
Verizon Regional Package	$39.95		√	√		5	Yes
Verizon Freedom	$54.95		√	√	√	5	Yes
MCI Neighborhood Complete	$55.99		√	√	√	5	Yes
RCN Megaphone	$55.00		√	√	√	4	Yes
Comcast Connections Any Distance	$48.95		√	√	√	5	No
Vonage Premium Unlimited	$34.99		√	√	√	6	Yes
IDT America Unlimited	$39.95		√	√	√	6	No
AT&T CallVantage	$34.99		√	√	√	4	Yes
Cingular Nation	$49.99	600	Included in plan minutes plus unlimited nights and weekends			5	Yes
AT&T mLife National	$39.99	600				5	Yes
T-Mobile Get More National	$39.99	600				4	Yes

New York

Package Plan	Price	Wireless Anytime Minutes	Local Calling	Local Toll Calling	Long Distance	Add'l Calling Features	Voicemail
Verizon Regional Package	$44.95		√	√		5	Yes
Verizon Freedom	$59.95		√	√	√	5	Yes
MCI Neighborhood Complete	$49.99		√	√	√	5	Yes
Vonage Premium Unlimited	$34.99		√	√	√	6	Yes
AT&T CallVantage	$34.99		√	√	√	4	Yes
Cablevision Optimum Voice	$34.95		√	√	√	6	Yes
IDT America Unlimited	$39.95		√	√	√	6	No
Cingular Nation	$49.99	600	Included in plan minutes plus unlimited nights and weekends			5	Yes
AT&T mLife National	$39.99	600				5	Yes
T-Mobile Get More National	$39.99	600				4	Yes

*Checked box indicates unlimited minutes

Source: Respective company websites

More generally, a Banc of America Securities "Wireline Services Pricing Update" found that cable and VoIP charge prices well below the average for wireline bundle prices:

> In September, we noted that Cable and VOIP providers were the most competitive on wireline service bundle pricing. This remains the case as we saw $5 price declines from Vonage and Earthlink to $34.99 per month. Average wireline bundle prices would have to fall 30% to reach parity, an increase from the 20% decline required in September.[47]

61. Finally as discussed below, neither consumers nor the competitive process would benefit from a rule that prevented a BOC from offering two packages -- one with and one without LD -- whose price differences failed Dr. Selwyn's access charge imputation test.

3. Dr. Selwyn's calculation of "effective" prices for bundled service components is flawed and accepting his use of the results would harm competition.

62. At ¶ 23 Dr. Selwyn asserts that the price of toll in a package is the difference between the prices of two packages: one with toll and one without. He then proposes that that price difference be required to satisfy an imputation price floor—i.e., that the price for the combined service must be set high enough so that the price difference between the two bundles must exceed the imputed charge for the service added to the bundle. However, the price of any individual component of a bundle is not defined—e.g., if a company provides service A for $2 and service B for $3 and the bundle is priced at $4, there is no economically meaningful way to know whether service A is being sold for $1 and service B for $3, or service B is being sold for $2, while service A is sold for $2, or each is being sold at a $0.50 discount, or whether some other strategy is used to determine the prices. All we know for sure is that the bundle is priced at a 20 percent discount compared to the sum of the two individual services.

63. There is nothing anticompetitive about offering two services in a single bundle (or two different bundles) for which the difference in prices does not match the difference in costs. The competitive marketplace is filled with offers that would be ruled out by Dr. Selwyn's "test." For example, competitive retailing operations often include Buy One, Get One Free offers. The highly competitive wireless mobile service market is replete with offers of "free night and weekend minutes," provided you purchase weekday minutes. Such competitive pricing arrangements would be ruled out by Dr. Selwyn's proposal. Yet the fact that such package offerings are so pervasive in unregulated competitive markets demonstrates that they are pro-competitive and that they benefit consumers.[48]

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[47] Banc America Securities Wireline Services Pricing Update, at 3.

[48] Dr. Selwyn's examples of Verizon bundles from which he infers a monthly price of $2 for unlimited intraLATA toll calling seem to suggest that he believes the stand-alone cost for such calling would be significantly higher and as a result the packages that include such calling should be more expensive. But forcing Verizon to raise

(continued...)

64. Consider another example to illustrate the fallacy and the harm with Dr. Selwyn's proposed approach. CVS sells a headache remedy and a sinus remedy for $2.99 and $3.49, respectively, while the combination (sinus/headache pill) is sold for $3.99. Dr. Selwyn's proposal would require the $0.50 price difference between the combination and the $3.49 sinus remedy to exceed the full incremental cost associated with selling the stand-alone headache remedy. Yet, assuming that the stand-alone headache remedy cost $2.00 and the cost of the combined product were only $3.00, this could needlessly prevent CVS from offering consumers the savings that come from bundling the two ingredients in a single product—i.e., it would require CVS to sell the bundle for $1.50 more than needed according to proper economic principles.[49]

B. Dr. Selwyn's attempt to expand imputation requirements beyond carrier access is unnecessary and harmful.

65. Dr. Selwyn's proposed imputation rule is based on a distorted view of competition that ignores availability of inputs. His attempt to expand imputation requirements beyond carrier access [as required by Section 272(e)(3)] to functions that competitive firms typically self-provide (e.g., accounting, marketing, payroll, legal, etc.) is both unnecessary and harmful.[50] A competitor certainly does not need access to an ILEC's Legal or Human Resources departments to compete. Similarly, billing and collection services, and marketing are self-provided by competitors or available in the market, and thus are not essential facilities in need of imputation.

66. In addition, under price cap regulation, there would be no consumer benefit from these attempts to apportion to local service all of the efficiencies obtained from integration. As explained above, price cap regulation determines prices for regulated ILEC interstate services. There are no direct effects of accounting cost allocations on the ILECs' ability to set prices for regulated services. In particular, the interstate regulated services in question are no longer affected by earnings-sharing requirements or by low-end adjustments. Thus, consumers of interstate regulated services would be unaffected in the prices they pay or the service characteristics or quality levels they purchase by AT&T's proposed assignment of costs between regulated and unregulated jurisdictions. Thus, such imputation would not protect consumers of the regulated services but would harm competition in long distance by acting as a price umbrella for competitive long distance services.

(...continued)

the price of such a package would clearly be a form of protectionism in light of the fact that companies such as the cable companies and AT&T have comparable offerings.

[49] David S. Evans, Michael Salinger, Why Do Firms Bundle And Tie? Evidence From Competitive Markets And Implications For Tying Law, *Yale Journal on Regulation,* forthcoming, 2004. http://ssrn.com/abstract=550884

[50] See Selwyn Declaration at¶¶ 15-18.

C. Adopting Dr. Selwyn's Proposal to Use Accounting Costs Would Reduce Economic Efficiency

67. Dr. Selwyn's cross subsidy test relies on a fully distributed cost ("FDC") methodology, which has been widely discredited for use in determining whether prices are anticompetitive. Widely accepted principles of competition analysis reject the use of FDC in assessing predatory pricing claims.[51] Yet, not only would Dr. Selwyn rely on FDC, he would require additional, more detailed allocations, and he would add additional mandates to compute "fair market values" for selected inputs and impute them into his price floor. Adopting these proposals would require an entirely new and burdensome set of studies for no purpose other than to hinder the BOCs' ability to take advantage of efficiencies and pass on savings to consumers.

1. Dr. Selwyn's Accounting Cost Proposal is Inconsistent with Economic Principles and FCC Pricing Rules

68. Dr. Selwyn's proposed cross-subsidy test has no basis in economic principles and would stifle investment incentives. In economics, a service is not receiving a cross-subsidy unless it is priced below its own TSLRIC. Economic principles clearly mandate the use of direct incremental costs to assess whether a service is receiving a subsidy. If the revenues added by a service exceed the added costs, then the service is not subsidized.

69. Moreover, the FCC has clearly defined cross-subsidization in terms of incremental costs rather than FDCs. "In order to avoid a cross-subsidy between two such services that are provided over a common facility, each service must recover at least its incremental cost, and neither service should recover more than its stand-alone cost."[52] Thus, the Commission has rejected the definition of cross-subsidization proposed by Dr. Selwyn (at ¶ 8).

70. At the same time, economists generally reject cost allocation studies when the resulting measure of cost is to be used as a basis for any economic decision and particularly for pricing. Distinguished economists who have testified on behalf of AT&T oppose the use of the FDC methodology in cross-subsidy tests and for other purposes. More importantly, they specifically rule out the inclusion of indirect or shared and common fixed cost allocations for that purpose.[53] Professors Kaserman and Mayo, have written that "...the application of FDC methodologies undermines any ability to use price and 'costs' of services to make legitimate

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[51] For example, the Areeda & Turner test for predatory pricing recognizes that the conceptually correct test compares prices with marginal costs and uses average variable cost (AVC) as a proxy because of the difficulty in calculating marginal cost in a litigation setting. See Hebert Hovenkamp, *Federal Antitrust Policy: The Law of Competition and Its Practice,* Second Edition, West Group, 1999, at Section 8.2. Fully distributed costs are not part of either measure.

[52] FCC 99-007, Third Report and Order and Order on Reconsideration of the Second Report and Order, Docket No. 96-128, released: February 4, 1999, par. 56.

[53] See for example William J. Baumol, "Minimum and Maximum Pricing Principles for Residual Regulation," *op. cit.,* p. 238.

inferences about the absence or existence of cross-subsidies."[54] According to Professor Baumol "[t]his traditional tool of price regulation [i.e., FDC] is now generally discredited and is increasingly being abandoned in regulatory practice. . ."[55]

71. Dr. Selwyn's expanded definition of cross-subsidization would introduce extraneous, incorrect factors into the analysis. His proposed re-definition of "cross-subsidy" ignores economics and contradicts previous FCC uses of the term. Moreover, the proposed redefinition is internally inconsistent: the definition proposed says that cross-subsidization is pricing below cost for either of two reasons: (a) using revenues from regulated services or (b) using assets or facilities of regulated services without proper compensation. Neither of those reasons have any application in an economic cross-subsidy test. In economics, a service is subsidized when it is priced below its incremental cost. Assigning a "fair share" of shared or common fixed costs to services or "just and reasonable compensation" for benefits provided from one service to another have nothing to do with the economic standard for cross-subsidy—the cross-subsidy standard advocated by AT&T's economists for over 20 years.

2. Dr. Selwyn's Suggested Changes to Part 64 Allocation Rules are Unnecessary.

72. Dr. Selwyn's proposed "improvements" to Part 64 cost allocations would not fix the fundamental problems with allocated costs; rather, if adopted, they would add new administrative complexity to a tool that is not relevant to the economic analysis of a price squeeze and, in fact, serves no useful regulatory purpose in today's price cap environment. Dr. Selwyn criticizes existing part 64 FDC allocations are arbitrary and not supported by cost-causation.[56] These factors imply that FDC allocations do not provide useful information for price floors. However, rather than abandoning cost allocations, Dr. Selwyn would foist even more arbitrary, complex and costly administrative burdens upon both the BOCs and the Commission.

73. The fundamental problem is that expanding FDC allocations in Part 64 would not change the fact that ILECs are integrated firms and rely on an integrated management structure employing integrated physical and human resources to provide a multiplicity of services. The proposed cost allocations would be meaningless. Indeed, AT&T presented this very argument to regulators in Massachusetts when requesting to be relieved of rate of return regulation for intrastate services:

> AT&T is an integrated, multijurisdictional company providing telecommunications services worldwide using an integrated national

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[54] Kaserman, David L., and John W. Mayo, *Government and Business: the Economics of Antitrust and Regulation*, The Dryden Press 1995, at 511.

[55] Baumol, William J., and J. Gregory Sidak, *Toward Competition in Local Telephony*, The MIT Press and The American Enterprise Institute for Public Policy Research, 1994, p. 56.

[56] Selwyn Declaration at ¶28.

> management structure and employing the same physical and human resources to provide international, interstate and intrastate services. Because AT&T's services used the same network, computers and other facilities whatever the jurisdiction, determining a cost basis for calculating an economically meaningful rate of return is impossible. Rationally determining the cost basis for purposes of pricing individual state subsets of those services is also an economically impossible task. Yet, Massachusetts ROR regulation requires that a fully-allocated cost basis be established and that the prices for AT&T's intrastate services be modified to reflect such cost allocations. Allocating AT&T's multistate costs to determine AT&T's Massachusetts costs, further allocating those costs between interstate and intrastate services, and yet further allocating the intrastate costs among numerous intrastate services is economically irrational as a basis for setting prices. There is no rational basis for believing that rates based on fully allocated costs are either fair or economically justified.[57]

74. The regulatory expedient of assigning fixed costs among categories (e.g., between regulated and unregulated or between interstate and intrastate jurisdictions), in proportion to variable costs or demand volumes, though "reasonable," is not cost-causative, and the resulting costs are not economically meaningful for the purposes at issue here. It might be equally reasonable to allocate railroad overhead costs to services by volume, weight or value, but shippers of feathers, coal and diamonds would undoubtedly disagree about the results. In Dr. Baumol's and Dr. Willig's prophetic words some 17 years ago,

> Fully allocated cost figures and the corresponding rate of return numbers simply have zero economic content. They cannot pretend to constitute approximations to *anything*. The "reasonableness" of the basis of allocation selected makes absolutely no difference except to the success of the advocates of the figures in deluding others (and perhaps themselves) about the defensibility of the numbers. There just can be no excuse for continued use of such an essentially random, or, rather, fully manipulable calculation process as a basis for vital economic decisions by regulators.[58]

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[57] Initial Brief of AT&T Communications of New England, Inc., dated April 23, 1992, in the Commonwealth of Massachusetts Department of Public Utilities proceeding DPU 91-79, at 42-43. Citations omitted.

[58] W. J. Baumol, M. F. Koehn and R.D. Willig, "How Arbitrary is 'Arbitrary'? – or, Toward the Deserved Demise of Full Cost Allocation," *Public Utilities Fortnightly*, Vol. 120, No. 5, September 3, 1987 at 21.

3. The claim that economies of integration must "inure to the benefit of the BOC's local service" is bad law and bad economics.

75. Dr. Selwyn claims (at ¶¶ 11-12) that the economies of integration must "inure to the benefits of the BOC's local service." This assertion has no basis in economic principles and implementing it would harm consumers. Dr. Selwyn is wrong in his conclusion[59] that imputation means that *all* of the gains from integration inure through the imputation formula to the local exchange service. In fact, any reduction in the ILEC's incremental cost of providing long distance service immediately reduces its price floor, as economists would calculate that floor. Similarly, in competitive markets, any reduction in incremental cost of providing long distance service would result in price reductions for that service rather than local exchange services.

76. Dr. Selwyn suggests that the gains from integration attributable to the BOC's "legacy local service monopoly"—e.g., joint marketing, and billing systems—should be assigned to assure that regulated local services retain the benefits of such "joint and common" resources.[60] Whether "legacy" LEC resources were developed under regulation is not relevant. The economic concept of subsidy does not consider historical costs. In fact, regulated customers can only benefit from joint and common resources if public policy enables BOCs to compete effectively based on their forward looking costs. To see this, consider an example where an ILEC could compete effectively under the economic imputation test, but not under the FDC test. In this case, others would capture business that the ILEC could have supplied, thereby reducing output by the integrated firm and reducing rather than facilitating economically efficient integration. Cross-subsidy rules can no longer ignore the economically correct approach because there are now many firms competing to provide the both à la-carte and bundled services, including at least cable TV and wireless firms that compete for packages of service that include toll and local usage as well as other services.

77. Dr. Selwyn's proposed requirement that all new investment costs be allocated to the new competitive service is a transparent attempt to protect AT&T from an ILEC development of new services. While all costs that are incremental to the supply of a new service should be recovered by that service, costs that are shared between existing and new services should be recovered where market conditions permit, just as AT&T, MCI, cable suppliers and wireless companies recover the shared costs of their old and new services through the revenues their (largely) packaged services generate. It is pointless, and bad economics, to try to ascribe all of the investment costs of a joint-use network to the new unregulated services the network makes possible[61]

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[59] *Id.*

[60] See Selwyn declaration at ¶¶ 16, 17.

[61] In the words of Fred Kahn and Bill Shew: "The marginal costs of access are what they are in the system that is optimally designed to satisfy all demands it serves." See Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications Regulation: Pricing" *Yale Journal on Regulation*, Vol. 4, No. 2 (Spring 1987).

78. Seeking to protect AT&T would lead to distortions of the competitive process—e.g., it could lead to even more loss of service by the LECs to cable TV firms and wireless firms as well as traditional CLECs and IXCs that would presumably not be subject to the same rules as the BOCs. A firm can only achieve economies of scope if it can sell both services at issue; thus, rules that inhibit sales of the bundled service will prevent the realization of economies of scale and scope.

79. Dr. Selwyn's proposals are an attempt to continue the cost inefficiencies of section 272(b) and (c) long after the separate affiliate requirements sunset. Imposing 272(b) and (c) requirements after sunset has nothing to do with anticompetitive pricing. These provisions were a very restrictive and costly safeguard that Congress clearly believed should be of limited duration. These restrictions have no bearing once the separate affiliate requirement has sunset.

80. According to Dr. Selwyn, Sec 272(b) and (c) require cost accounting following 47 CFR 32.27, where the transfer price is the greater of fully distributed cost or fair market value. Moreover, he claims that their purpose was to "facilitate realization of integration efficacies while assuring that the gains from such integration inure to benefit of the LEC's regulated services."[62] First, Dr. Selwyn is incorrect in stating that 47 CFR 32.27 requires asymmetrical accounting for 272 affiliate transactions. Part 32.27(d) clearly states that the comparison of fully distributed cost and estimated fair market value does not apply to transactions between the BOC and its 272 affiliate. The FCC believed that the other non-discrimination requirements created an environment whereby the transactions with the 272 affiliate could be presumed to meet the market rate test.[63]

81. Second, contrary to Dr. Selwyn's assertions, the section 272 safeguards were designed to prevent integration for an interim period after the grant of section 271 authority in a particular state. Once integration occurs, the ensuing gains should be apportioned however market conditions permit. As long as the purchasers of regulated services pay rates no higher than they otherwise would, they are not harmed by the firm's provision of unregulated services. In contrast, under Dr. Selwyn's rules, retail prices of unregulated services would be raised to needlessly high levels, so that fewer unregulated services would be provided and all customers would be made worse off. When a new unregulated service is supplied, consumer surplus increases, sometimes by immense amounts.[64] By insisting that a disproportionate share of the increased consumer surplus be assigned to customers of regulated services, Dr. Selwyn would reduce the total increase in consumer surplus—a classic case of killing the goose that lays the golden eggs.

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[62] Selwyn Declaration at ¶12.

[63] Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996, CC Docket No 96-150, *Report and Order*, 11 FCC Rcd 17539, 17601, ¶ 137 (1996) ("*Accounting Safeguards Order*").

[64] Jerry A. Hausman, "Valuing the Effect of Regulation on New Services in Telecommunications," *Brookings Papers on Economic Activity, Microeconomics*, 1997, pp. 1 - 38.

4. Dr. Selwyn's "fair market value" approach is not consistent with the Telecom Act, and adopting it would harm consumers

82. Dr. Selwyn confuses imputation with a "fair market value" concept that he would apply to selected BOC functions for use in setting price floors for toll and other services. This proposal introduces another unneeded, potentially costly requirement. He claims that the 1996 Telecom Act imputation rule is based on fair market value, and on the basis of this claim, he seeks to extend fair market value imputation to services that are neither essential nor tariffed services.[65]

83. The imputation standard of Sec. 272(e)(3) does not mention "fair market value," nor does it mention any functions other than network access. Section 272(e)(3) states that: the BOC "shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own service), an amount for ***access*** to its telephone exchange service and exchange ***access*** that is no less than the amount charged to any unaffiliated interexchange carriers for such service." This requirement is quite specific and should not be extended to any other BOC functions as Dr. Selwyn seeks to do in his ex parte. Certainly, there is no basis for an economist to reason that Congress intended a broader requirement. Estimating fair market value for other functions that are provided by a myriad of companies would be a costly waste of resources. It would be costly because it would require estimation and presumably arbitration and/or litigation to agree to the value of the services. It would be waste of resources because imputation is required only for essential inputs, whereas the inputs, such as billing and collection, mentioned by Dr. Selwyn as candidates for fair market value analysis, are self provided by numerous competitors including AT&T and/or are widely available in the market place.

D. Dr. Selwyn's proposal to classify ILEC long-distance service as dominant makes no economic sense.

84. Dr. Selwyn asserts [at ¶ 31] that implementation of the statutory requirement for imputation, (§ 272(e)(3)), effectively requires that BOC long distance service be reclassified as dominant. Otherwise, he says, BOCs would not be required to file tariffs for their interstate long distance and private line services so that imputation could not be enforced before prices go into effect. This claim is ludicrous and dangerous. As we have shown above, the imputation required by 272(e)(3) is an accounting mechanism not a pricing mechanism for long distance service. Thus, it is not necessary to review a long distance rate to determine if the imputation has occurred.

85. We show below that long distance today is far more competitive than it was in 1995 when the Commission found that AT&T was no longer dominant in the provision of interstate interexchange services. Concentration is lower, capacity is higher and technology has further

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[65] Dr. Selwyn claims, at ¶ 2, that: "BOCs are already required by Section. 272(e)(3) to comply with a market value imputation standard with respect to access service (where "fair market value" is for this purpose defined as the tariff rate)."

reduced barriers to entry. No firm, let alone an ILEC, has the ability to exercise market power by withholding supply from the marketplace. And, as the Commission has recognized in the past, imposing the regulatory requirements associated with dominance would impede competition to the detriment of consumers in effectively competitive markets.

1. ILECs have no market power in the long distance and no prospect of attaining market power.

86. There is broad agreement among economists and regulators that firms providing services subject to effective competition should be removed from regulation—in this context, classified as nondominant. The Commission has defined non-dominance as not possessing the power to control price or not having market power.[66] In 1993, AT&T filed a motion to be reclassified as a nondominant carrier, and in the course of that Docket, the Commission explained carefully what it means for a firm to be dominant in a market and the type of evidence to which the Commission would give substantial weight in determining whether a firm was dominant. In its October 1995 Order, the Commission stated that it would

> assess whether AT&T possesses market power in the overall interstate, domestic, interexchange market. Applying well-accepted principles of antitrust analysis, the following discussion first focuses on: (1) AT&T's market share; (2) the supply elasticity of the market; (3) the demand elasticity of AT&T's customers; and (4) AT&T's cost structure, size and resources. Our analysis of AT&T's market power thus begins with an assessment of these general characteristics of the interstate, domestic, interexchange market.[67]

87. Of these four indicia of market power, Dr. Selwyn addresses only one, namely his view of the market share of particular ILECs. Nearly ten years have passed since the Commission assessed these four aspects of the long distance marketplace, and none of them today would support an argument that the long distance marketplace is any less competitive today than it was then. Concentration is lower today than it was in 1995. On the supply side, there is more capacity available in the market for long distance voice and data services. Particularly since the meltdown after the late1990s, there is far more excess capacity in long distance transport than there was in 1995.[68] New carriers have evolved since 1995 and new services based on new platforms are available to long distance customers. In response, residential customers have shifted large amounts of long distance traffic to wireless suppliers and business customers (and some residential customers) are moving voice and data traffic over broadband connections.

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[66] Policy and Rules Concerning Rates and Facilities Authorizations for Competitive Carrier Services, CC Docket No. 79-252, First Report, 85 F.C.C.2d at 6, 20-21.

[67] In the Matter of Motion of AT&T to be Reclassified as a Non-Dominant Carrier, *Order*, released October 23, 1995 at ¶ 38.

[68] See Declaration of Dennis W. Carlton, Hal Sider and Alan Shampine, on attached hereto, WC Docket No. 02-112 and CC Docket No. 00-175 June 30, 2003, ¶¶ 37-40.

The existing capacity and new technologies such as VoIP imply that relative long distance carrier costs are not and will not be a source of market power for the BOCs.

2. Dr. Selwyn's claims regarding market share in long distance have no basis in economic principles.

88. Market share is only one component of potential market power, and standing alone, does not tell an economist whether market power exists. A firm with even 100% market share may not have market power, particularly, for example, if barriers to entry are low. Dr. Selwyn's analysis, therefore, is woefully incomplete.

89. Beyond that, the shares presented by Dr. Selwyn are not, and do not purport to be, market share measures for economic purposes. Rather, they represent the fraction of Verizon's residential local exchange lines that have presubscribed to Verizon's long distance service. This measure, of course, does not reflect a proper market share in a properly defined market. The deficiencies are legion.

90. First, the measure ignores the fact that toll can be provided without conventional wireline service. That is, as AT&T acknowledges, wireless carriers and VoIP carriers supply toll services that compete with ILECs and AT&T, and those services are excluded from Dr. Selwyn's measure. Similarly, toll services supplied by cable companies and by CLECs to their customers (and independent ILECs to their customers) are excluded from the analysis.

91. Second, the measure ignores business toll services, which is a high-margin segment in which AT&T and MCI increasingly specialize—e.g., according to one report, long distance companies obtain about 70 to 75 percent of their revenues from business[69]—and in which the BOCs have made much less progress.[70]

92. Third, even within the residential segment, ILECs disproportionately provide toll service to the low-volume users among their local exchange customers that other long distance or vertically integrated companies exclude by means of packages that are aimed at medium and high volume users. Other market share measures (e.g., revenue-based) show that ILECs have modest shares (much smaller than Dr. Selwyn's flawed measures) when the markets and competitor are properly defined

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[69] "Long distance companies, in the wake of substantial, long-time competitive pricing in this market, generate lower but still substantial percentages of their revenue from the consumer market, around 25% to 30%." See Banc of America Securities, Equity Research, Research Brief Wireline Communications, Wireline Services Pricing Update, January 13, 2004, at 6.

[70] See, for example, Ken Belson, "AT&T Won't Seek New Residential Customers," New York Times, July 23, 2004.

93. Fourth, long distance services are undifferentiated services; that is, there are generally no quality differences or other distinguishing characteristics of a particular carrier's services (at least with respect to intramodal competitors). With respect to such services, as AT&T's economists argued in the AT&T Non-Dominant proceeding, market share should be measured using capacity rather than the share of customers or revenue.[71]

3. Declaring ILEC long distance services dominant would impose regulatory requirements that have no place in competitive markets.

94. There is general agreement that if a carrier has no market power in a relevant product and geographic market for a service, it should not be subject to the full panoply of Title II regulation.[72] The Commission has identified at least two good reasons for this agreement.

95. First, asymmetric regulation of particular firms or particular technologies or platforms in effectively competitive markets inevitably distorts the competitive market outcome. In such circumstances, ordinary regulatory decisions, no matter how well-intentioned, have unanticipated consequences, which harm the competitive process and harm consumers. As AT&T claimed in 1993:

> In these circumstances, no legitimate purpose is served by continuing to classify AT&T as dominant, or by subjecting AT&T to direct economic regulation. To the contrary, such regulation imposes "barriers and burdens [that] impair competition by delaying or deterring carriers in their service and rate offerings and causing them to bear additional costs," as the Commission has found [footnote] Indeed, in a competitive market, advance tariff review procedures and other constraints serve only to provide competing firms with "a regulatory forum to challenge and delay" each other's service and pricing innovations, resulting in the protection of competitors rather than consumers. [footnote] Thus, direct economic regulation is not merely unnecessary; it impedes the "dynamism" of a competitive market and "impose[s] both direct and indirect costs on users"[footnote] [73]

[71] "…in the case of the long distance market, it is more meaningful to review market share measures based on the relative amount of transmission capacities held by interexchange firms," D.L. Kaserman and J.W. Mayo, "Is AT&T 'Dominant'? An Assessment of the Evidence," June 1995, filed ex parte by AT&T June 12, 1995 in CC Docket No. 79-252 (at 14).

[72] For example, in its Competitive Carrier Proceeding, the Commission found that effective competition meant that market forces would ensure reasonable prices and that tariff filing requirements would only stifle price competition and service and marketing innovations. (*Policy and Rules Concerning Rates and Facilities Authorizations for Competitive Carrier Services*, CC Docket No. 79-252, Second Report and Order, 91 F.C.C.2d at 71.

[73] Motion for Reclassification of American Telephone & Telegraph Company as a Nondominant Carrier, CC Docket No. 79-252, September 22, 1993 at ¶15.

Dr. Selwyn's concern that BOC long distance services be required to file tariffs so that the Commission could "review [and]…enforce the statutory imputation requirement" is precisely the forum for challenge and delay against which AT&T previously warned.

96. Second, the FCC found that the administrative costs of regulation of non-dominant firms represented waste and that its resources—as well as those of the regulated firms—could doubtless find better employment elsewhere.[74]

VI. CONCLUSION

97. AT&T is asking this Commission to implement regulatory obstacles that would make it more difficult for the BOCs – and the BOCs alone – to offer consumers attractively priced services. Dr. Selwyn's allegations and purported "remedies" ignore that modern economics and case law generally conclude that anticompetitive pricing (of which a price squeeze based on monopoly leveraging is but a special case) is rarely attempted and even more rarely successful. The remedy AT&T seeks will create far more harm than good.

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[74] *Tariff Filing Requirements for Nondominant Carriers,* Further Notice, CC Docket No. 93-96, 84 F.C.C.2d at 447-48.

ATTACHMENT 1: SUPPLEMENTARY INFORMATION ON TELECOMMUNICATIONS COMPETITION

A. Additional information regarding cable telephone services

In the text we describe the substantial presence of cable broadband and voice services as well as the expected rapid growth of VoIP-based cable telephony services. The ability of carriers offering these services to achieve this growth is shown by the following:

- Cable companies are estimated already to have about 3.5 million telephone subscribers and that number is forecast to grow rapidly with the expansion of VoIP telephony services in their systems to about 17 million subscribers by 2008.[75]

- Cable facilities already pass almost 103 million occupied homes in the US, including almost 96 million homes passed by cable modem service.[76]

- By year-end 2003, cable companies offered circuit-switched voice telephone services to approximately 15 percent of homes nationwide[77];

- By the end of 2004, cable companies plan to offer VoIP to more than 24 million homes over their networks; and, they plan to offer it to at least 20 million more the following year. [78]

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[75] David Reed, presentation on VoIP Technology, chart entitled "Cable Telephony Subscriber Growth," Cable Television Laboratories, Inc. 2004, June 8, 2004.

[76] NCTA Industry Overview, http://www.ncta.com/Docs/PageContent.cfm?pageID=86, data for December 2003, accessed July 22, 2004

[77] Before the Federal Communications Commission, Docket Nos. 01-338CC, 96-98, 98-147. Ex Parte Technological and Market Developments Since the Triennial Review Further Demonstrate that Competitors Are Not Impaired Without Access to Unbundled Mass Market Switching (June 2004) at 1 ('Verizon Ex Parte").

[78] More specifically: (1) *Time Warner* now offers VoIP service in 16 markets and will deploy VoIP to "essentially all" of its markets nationwide by the end of 2004, where it passes a total of 19 million homes. *Cox* already offers circuit-switched voice service to more than half of the 10 million homes it passes nationally, and is now moving to roll out VoIP service in additional markets. *Comcast* already offers circuit-switched voice service to more than nine million homes nationally and will offer VoIP to half of the 40 million homes it passes by the end of 2005 and to all of the homes it passes by the end of 2006. *Charter* has announced that it plans to offer VoIP services to at least one million of the homes that it passes nationally in 2004. Cablevision began offering VoIP service to 4 million homes in New York metropolitan area in November 2003 and has been adding 3,200 new customers per week. The cable company ended Q1 2004 with 70,800 VoIP customers, up by 42,200 for the quarter. See: Reuters, *The New York Times*, "Comcast Plant Internet Telephone Service," p. C5 (May 27, 2004). Charter Communications 2003 Annual Report at 22 Converge Network Digest, "Cablevision is Adding 3,200 Consumer VoIP Lines per Week in New York." May 10, 2004 http://www.convergedigest.com/DSL/lastmilearticle.asp?ID=11068. Accessed July 28, 2004.

- Within two years, roughly 82 percent of US households will have access to voice telephone service from their cable operator.[79]

- VoIP offers cable companies an extremely low-cost way to completely bypass the BOC's access lines. For example, Cablevision "is spending about $133 on capital costs to hook up each subscriber. With a price of $34.94 per month and a profit margin of 40-45 percent, Cablevision can recoup that investment just 10 months after signing up a new customer."[80]

- A report by Cox suggests that VoIP will facilitate expansion of voice service to a greater percentage of customers, including rural customers. Cox, a pioneer in circuit switched cable telephony, stated that: "VoIP technology enables Cox to introduce phone services to customers the company isn't currently reaching, without stranding the capital it has invested in circuit-switched operations."[81] Thus, "Cox, … proclaimed 'VoIP is now ready for prime time.'"[82]

- Comcast considers residential telephone service a "growth business" and "fundamentally believe[s] that the future is VoIP."[83] In response to Comcast's announcement of its VoIP plans, a UBS analyst opined "Comcast will likely become one of the biggest phone companies over the next decade. … We expect [ILECs] to see increased pressure on residential access lines in 2005 as these deployments occur."[84]

- Cable companies are adding telephony to their bundle not only to capture new revenues but also to reduce churn of existing customers and losses to satellite TV. *Barron's*, recently reported that: "The cable industry believes anyone who signs up for all three is unlikely to bolt and sign with the competition."[85]

- Cable telephony services are priced extremely aggressively compared to BOC services. See Section V.A. Besides the packages described in the text:

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[79] J. Halpern, et. al., Bernstein Research Weekly Notes, "US Telecom and Cable: Faster Rollout of Cable Telephony Means More Risk for RBOCs, Faster Growth for Cable," Jan. 9, 2004, at 4.

[80] Communications Daily. "Cable MSOs Pick Up VoIP Pace, Shrug Off Vonage." Vol 24, Issue 100, May 24, 2004. Moreover, according to the article: a Cablevision executive stated that, "The investment in VoIP is really quite level if you have a high-speed access business. … As penetration goes up, the cost goes down."

[81] *Id.*

[82] *Id.*

[83] Peter Grant, *The Wall Street Journal*, "Comcast Is to Expand Trials Of Web-Based Phone Service," p. B10 (October 9, 2003).

[84] *Id.*

[85] Eric J. Savitz, *Barron's*, "Talk Gets Cheap: Internet telephony is Bad News for the Bells, But Maybe Great News for the Cable Guys," (May 24, 2004).

- Cox states that customers can save on their monthly bills by bundling services like Digital Cable and High-Speed Internet.[86] Cox's Digital Phone packages include: Connection Unlimited—with unlimited nationwide and long-distance minutes, 14 calling features such as Call Forwarding, 3-way Calling, Caller-ID, Call Waiting, and voicemail for $49.95 a month; Connection 100—with all the features of Connection Unlimited but with 100 minutes of nationwide and long-distance minutes per month for $34.90/month; and Basic Line—with no included minutes and an extra $4.95 for voice mail costs $4.95 a month. The pricing for this plan is $11.75 a month if the customer has multiple Cox services. If not the price for this package is $13.00 a month.[87]

- Comcast offers local and long distance telephone service for $48.95 or less.[88]

- Time Warner has introduced a package of unlimited local and long distance telephone service for $39.95, when purchased with other services.[89]

- Cablevision offers unlimited local and long distance telephone service for $34.95. Cablevision also recently introduced a bundled offering that includes unlimited local and long distance telephone calls plus digital cable and high speed Internet access for $89.85, about the same amount many of its customers already pay just for digital cable and high speed Internet access. Customers "are essentially receiving their voice service for free," according to Cablevision.[90]

Evidence that cable companies are also targeting business customers includes the following:

- "[Cablevision] Lightpath provides voice, data, and Internet communications services over a state-of-the-art fiber-optic network to the New York, New Jersey, and Connecticut business market . . . with . . . more than 140,000 access lines and 18,000 Internet circuits."

- Cox Business Services provides data, voice, and transport services to more than 100,000 customers. More than 320,000 businesses lie within 100 feet of Cox's network, providing Cox a "significant opportunity."

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[86] Cox Communications Bundled Services. http://www.cox.com/Digitalservices/, accessed July 28, 2004.

[87] Cox Communications Digital Telephone http://www.cox.com/fairfax/digitaltelephone/default.asp, accessed July 28, 2004.

[88] Comcast Products & Services. http://www.comcast-ne.com/customize.php Accessed August 3, 2004.

[89] Time Warner Digital Phone http://www.timewarnercable.com/corporate/products/digitalphone/default.html Accessed August 3, 2004.

[90] Cablevision Products and Services http://www.cablevision.com/index.jhtml;jsessionid=VJCHKGNLX5YESCQLASDSFEQKBMCIMI5G?pageType=prodserv Accessed August 3, 2004

- Time Warner: "We've got an infrastructure there that is just ripe for commercial services . . . . We pass 1.2 million businesses . . . .'"[91]

B. Supplemental data on substitution of wireless for wireline services

The data on wireless substitution in place of wireline usage are from reports by financial and industry analysts: Merrill Lynch estimated that approximately 23 percent of all voice minutes were wireless in 2003 and that wireless could make up approximately 29 percent of all voice minutes in 2004.[92] And the Yankee Group estimates that "U.S. households make 43 percent of their long-distance calls on wireless phones."[93]

Moreover the FCC's own data reflect the impact of these developments on wireline usage. The most recent data show that average residential wireline toll usage has declined rapidly in the wireline segment of the industry – from an average of 149 minutes per month in 1997, down to only 90 per line per month in 2002; or by 40 percent over the past five years.[94]

A growing number of customers have abandoned their wireline phones altogether. Research conducted by In-Stat/MDR reveals that as of February 2004, 14.4 percent of consumers in the United States use wireless phones as their primary phone.[95] According to the Cellular Telecommunications and Internet Association, "163 million Americans use wireless telephones in addition to their home landlines and 7.5 million to 8 million consumers use wireless telephones only."[96] And, these numbers are expected to grow dramatically. Of course, even wireless customers that retain wireline service can use wireless telephones to make toll calls.

Evidence that "cutting the cord" will continue to grow from the levels described in the text is as follows:

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[91] Market News Publishing, "Cablevision Systems Corp – Lightpath Offers Next Generation Services Using DWDM Solution." December 2, 2003; Cox Communications News Releases, "Enterprise Presents Even 'Bigger' Opportunity for Cox Business Service in 2004" March 29, 2004; Verizon Ex Parte at 7; Andrea Figler, "Turning Business Into Customers" Cable World, December 9, 2002.

[92] Verizon Ex Parte at 12.

[93] Yankee Group News Release, U.S. Consumer Long Distance Calling is Increasingly Wireless, Says Yankee Group. March 23, 2004.

[94] Industry Analysis & Technology Division, Wireline Competition Bureau, Statistics of the Long Distance Telecommunications Industry at Table 20, May 2003.

[95] In-Stat MDR, *"Cutting the Cord: Consumer Profiles and Carrier Strategies for Wireless Substitution,"* (February 2004) ("February In-Stat/MDR Report") at 1.

[96] Peter Brownfield, *FoxNews.com*, "Cell Phone Directory Raises Concerns," (May 13, 2004).

- Approximately 2-3 million additional wireless customers are now giving up their wireline phones each year.[97]

- An In-Stat/MDR study predicts that by year-end 2004 as many as almost 14 million wireless subscribers will have given up their landline phone and, by 2008, 29.8 percent of wireless subscribers will have done so.[98] This translates into 57 million subscribers without landline service in four years.[99]

C. Additional data on rapid growth of broadband-based services.

As stated in the text, growth of broadband Internet access will stimulate the substitution of messaging for voice services. We note here that such substitution has been dramatic for some time: a 2002 J.D. Power and Associates study showed that 92 percent of U.S. dial-up subscribers to the Internet are communicating by e-mail instead of by long distance calling.[100] On a nationwide basis, use of e-mail, instant messaging, and VoIP combined have resulted in a 47 percent reduction in long distance usage among Internet subscribers.[101] Given improvements in Internet access and service quality, we expect to see even more dramatic substitution going forward.

In considering the VoIP pricing plans described in the text, it should be noted that, not only are these services priced well below conventional wireline offerings; they are being aggressively marketed and developed by their providers. For example, Vonage offers the Residential Premium Unlimited Plan, which includes local and toll calls, as well as a set of vertical features and capabilities allowed by VoIP technology. In announcing a recent price reduction, Vonage stated that "features and hardware remain at no cost, with no annual contract and money-back guarantee within 14-days of sign-up."[102] (See our discussion of AT&T's and MCI's increased emphasis on VoIP to provide local and toll services to residence customers and business customers.)

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[97] S. Ellison, IDC, U.S. Wireless Displacement of Wireline Access Lines, Forecast and Analysis, 2003-2007 at 16, Table 9 (August 2003

[98] In-Stat MDR, "*Cutting the Cord: Consumer Profiles and Carrier Strategies for Wireless Substitution,*" (February 2004) ("February In-Stat/MDR Report").

[99] *Id.*

[100] J.D. Power and Associates, "2002 Syndicated Residential and Internet Customers Satisfaction Study," August 2002.

[101] *Id.*

[102] *PRNewswire,* "Vonage® Drops Residential Premium Unlimited Plan by $5 to $29.99," May 17, 2004.

The estimates of the impact of VoIP in the text are conservative compared to at least one longer term forecast that concludes that consumer use of VoIP could reach 40% of the U.S. market by 2009.[103]

Moreover, wireless carriers also now offer a variety of services that compete for data traffic as well. And as 3 G technology is deployed, wireless will be even better able to replace wireline services.

D. Additional data on AT&T and MCI

VoIP services from AT&T are already widely available; and as emphasized in the text, the rapidity with which AT&T has deployed its CallVantage offering shows that entry barriers are low. Some additional details are that: (1) AT&T's Call Vantage Service includes a complete calling solution that provides unlimited local and long-distance domestic calling, including calls to Puerto Rico and the U.S. Virgin Islands, discount rates for international calling, and a suite of advanced features for an introductory price of $19.99 per month for six months;[104] (2) AT&T's July 12th announcement that it had completed the deployment in 100 major markets[105] beat its commitment "to expand AT&T CallVantage Service to 100 major markets by year's end as part of AT&T's growing strategic focus on IP-based communications services."[106]

The ability of MCI and AT&T to succeed in the business market and thus to remain viable network operators is supported by the fact that they have developed major networks to bypass the ILECs local access and serve business customers. AT&T has long offered local and long distance voice and data services for its business network customers. It did so, in part, by acquiring Teleport so that it could bypass the BOCs' local services for business customers, as well as hooking business customers to its network using special access to bypass switched access services. AT&T recently proclaimed that:

> [It] is the leading provider of communications services to business customers, offering a full range of leading-edge networking and communications solutions on a global basis .... We intend to widen the gap between AT&T and our

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[103] John Horrigan and Allen Hepner. *27% of Online Americans have Heard of VoIP Telephone Service; 4 Million are Considering Getting It at Home.* Pew Internet & New Millennium Research Council, June 2004. Also see Multimedia Research Group, Inc. *Cable Telephony Business Case and North American Forecast – 2004 to 2007*, published January 2004 for forecasts in cable telephony subscriptions and cable telephony service revenue.

[104] *PRNewswire*, "AT&T CallVantage Service Expands to Serve the Western United States," May 17, 2004.

[105] AT&T News Release JULY 12, 2004 AT&T, "CallVantage Service Now Available in 100 Major Markets Coast-to-Coast Rollout Expands to 28 New Markets And Seven Additional States. $19.99 Promotion Offers Unlimited Calling and Advanced Features." http://att.com/news/item/0,1847,13134,00.html, accessed July 22, 2004.

[106] *Id.*

competitors in the business market, while also improving our industry-leading cost structure and financial strength.[107]

AT&T's 2003 annual report reveals that AT&T:

- "[Is] the country's largest competitive local exchange carrier, with 4.5 million local access business lines and over 4 million local residential customers."

Similarly, MCI, via the acquisitions of MFS, UUNET and Brooks Fiber and its own deployment of local fiber systems as well as its substantial Internet and long distance backbone networks, has long been providing the full array of long distance and local services to business customers; and, as described in the text, MCI has made substantial progress to implement its ambitious program to migrate towards Internet-based voice services.

[107] AT&T Press Release: AT&T Announces Second-Quarter 2004 Earnings, Company to Stop Investing in Traditional Consumer Services; Concentrate Efforts on Business Markets, July 22, 2004

We declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on August 10, 2004.

Timothy J. Tardiff

William E. Taylor

Harold Ware